

ECONOMIC OUTLOOK

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TAX REFORM: A GOOD BILL THAT NEEDS IMPROVEMENTS

by
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Last December, President Reagan and some House Republican leaders, including Congressman Jack Kemp, went out on a limb and urged the House to pass a tax reform bill that they themselves would have opposed if it had been the final version of the bill. Reagan and Kemp argued that the Senate would fix the bill. Many, including myself, were skeptical. We were wrong.

The Senate bill is, even in its current form, a major improvement over present law and deserved the support it received. Its chief beneficial aspect is that it will have a positive impact on long-term economic growth, and for that reason, the U.S. Chamber of Commerce endorsed the bill.

However, there is an important caveat. During the first two years after implementation, the bill will have a negative effect on the economy. Four changes need to be made to avoid an economic downturn during the transition period and to make the long-term impact of the bill even more economically constructive than it is now. First, the tax rates should be reduced at the same time as the tax base is broadened; second, the capital gains tax rate needs to be reduced (or at the very least the capital basis needs to be indexed for inflation); third, the minimum tax needs to be reformed; and finally, the investment tax credit should not be repealed retroactively.

In the bill's present form, the reduction in individual tax rates would not be implemented until July 1, 1987, even though the tax base will be broadened effective January 1. Thus, the top individual tax rate for 1987 will be a "blended" rate of 38.5 percent, not 27 percent. This means that taxpayers will experience a large \$23 billion tax increase in 1987. This same mistake of phasing in marginal tax rate reductions was made in the Economic Recovery Tax Act of 1981 (ERTA). As a result, the recovery was delayed (and unemployment rose considerably), until July, 1983 when the marginal tax rate cuts were fully effective.

In many instances, 1987 tax rates will not be low enough to compensate for the bill's economically damaging tax base changes.

Tables 1 and 2 show the results of two econometric simulations performed to estimate the effect of moving forward the effective date of the cut in individual tax rates and the base broadening. If these provisions were made effective in 1986:3, real economic activity would be \$31.7 billion higher over the three years 1986 to 1988. The bulk of the improvement would be in consumer spending; however, residential and nonresidential investment would also benefit, rising by \$8.2 billion between 1986 and 1988. The increase in economic activity would lead to the creation of 900,000 new jobs during this period while having no noticeable effect on inflation or interest rates. Obviously, the positive impact on the economy would not be as large if the rate cut and base broadening were implemented simultaneously in January 1987 rather than in July 1986. Nevertheless, the gains would be substantial (see Table 2).

Besides mitigating the positive effects of lower tax rates, the blended rate that will be in effect in 1987 also encourages many taxpayers to delay activities which would result in the production or realization of income until the lower tax rates take effect. The House and Senate conferees should ensure that, in the final version of the tax

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TABLE 1

ECONOMIC IMPACT OF SHIFTING FORWARD THE
EFFECTIVE DATE OF THE INDIVIDUAL TAX REFORM
MEASURES FROM 1987:3 TO 1986:3

	1986	1987	1988	Cumulative Impact
Real GNP				
Difference ¹	3.3	17.9	10.5	31.7
Percent Difference ²	0.1	0.5	0.3	
Real Final Sales				
Difference ¹	3.7	18.7	1.8	24.2
Percent Difference ²	0.1	0.6	0.1	
Consumption				
Difference ¹	4.3	16.2	8.1	28.6
Percent Difference ²	0.2	0.7	0.3	
Nonresidential Investment				
Difference ¹	0.4	2.7	2.4	5.5
Percent Difference ²	0.1	0.6	0.5	
Equipment				
Difference ¹	0.3	2.1	1.8	4.2
Percent Difference ²	0.1	0.7	0.6	
Structures				
Difference ¹	0.1	0.8	0.7	1.6
Percent Difference ²	0.1	0.5	0.4	
Residential Investment				
Difference ¹	-0.6	1.3	2.1	2.8
Percent Difference ²	-0.3	0.7	1.2	
Industrial Production Index				
Difference ³	0.1	0.9	0.5	
Percent Difference ²	0.1	0.6	0.4	
Civilian Employment				
Difference ⁴	0.3	0.4	0.3	0.9
Percent Difference ²	0.2	0.4	0.2	
Consumer Price Index				
Difference ³	0.06	-0.01	-0.03	
Percent Difference ²	0.02	.00	-0.01	
3-mos. Treasury Bill Rate				
Difference ⁵	0.01	0.05	0.05	
Corporate Bond Rate				
Difference ⁵	-0.02	0.00	0.05	

(1) Difference from base in billions of 1982 dollars.

(2) Percent difference from base.

(3) Difference from base in index points.

(4) Difference from base in millions of jobs.

(5) Difference from base in percentage points.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University Macroeconometric Model of the U.S. economy. The base case contains the changes in tax rates and tax revenues as per the Senate Finance Committee's bill. The alternative case moves the effective date of the individual rate cut and base broadening to 1986:3 instead of 1987:3.

reform bill, base broadening and tax rate reductions take effect on the same date.

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TABLE 2

ECONOMIC IMPACT OF SHIFTING FORWARD THE
EFFECTIVE DATE OF THE INDIVIDUAL TAX REFORM
MEASURES FROM 1987:3 TO 1987:1

	1986	1987	1988	Cumulative Impact
Real GNP				
Difference ¹	0.0	10.7	8.3	19.0
Percent Difference ²	0.0	0.3	0.2	
Real Final Sales				
Difference ¹	0.0	11.3	-1.8	9.5
Percent Difference ²	0.0	0.3	-0.1	
Consumption				
Difference ¹	0.0	10.5	5.4	15.8
Percent Difference ²	0.0	0.4	0.2	
Nonresidential Investment				
Difference ¹	0.0	1.7	2.0	3.7
Percent Difference ²	0.0	0.4	0.4	
Equipment				
Difference ¹	0.0	1.3	1.5	2.7
Percent Difference ²	0.0	0.4	0.5	
Structures				
Difference ¹	0.0	0.4	0.5	1.0
Percent Difference ²	0.0	0.3	0.3	
Residential Investment				
Difference ¹	0.0	0.1	1.6	1.7
Percent Difference ²	0.0	0.1	0.9	
Industrial Production Index				
Difference ³	0.0	0.5	0.4	
Percent Difference ²	0.0	0.4	0.3	
Civilian Employment				
Difference ⁴	0.0	0.3	0.2	0.5
Percent Difference ²	0.0	0.3	0.1	
Consumer Price Index				
Difference ³	0.00	0.06	0.04	
Percent Difference ²	0.00	0.02	0.01	
3-mos. Treasury Bill Rate				
Difference ⁵	0.00	0.05	0.03	
Corporate Bond Rate				
Difference ⁵	0.00	0.01	0.02	

(1) Difference from base in billions of 1982 dollars.

(2) Percent difference from base.

(3) Difference from base in index points.

(4) Difference from base in millions of jobs.

(5) Difference from base in percentage points.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University Macroeconometric Model of the U.S. economy. The base case contains the changes in tax rates and tax revenues as per the Senate Finance Committee's bill. The alternative case moves the effective date of the individual rate cut and base broadening to 1987:1 instead of 1987:3.

Raising the capital gains tax rate from 20 percent to 27 percent will have an adverse impact on the ability of small businesses to raise equity capital because it will reduce the willingness of venture capitalists to take the risks involved in funding innovation and technological research. Higher capital gains tax rates reduce the liquidity and efficiency of capital markets. Moreover, higher capital gains tax rates reduce taxpayers' willingness to actually realize capital gains, thus reducing the amount of tax revenue that the

federal government actually receives. Experience shows us that following the cuts in the capital gains tax rate implemented in 1978 and 1981, revenues actually rose. This flaw in the bill could be repaired easily, either by retaining the existing 20 percent tax rate or, at a minimum, indexing the capital basis for inflation.

Two changes need to be made in the proposal's corporate minimum tax provisions. Although the subject is distressingly complex, the amount of revenue and the principles at stake are important enough to warrant widespread discussion. (Also, the proposed minimum tax is so comprehensive that we estimate that as many as one-third of the businesses in the United States would regularly pay taxes under the minimum tax).

The capital consumption system used for the minimum tax employs very long pre-1981 recovery lives under the straight-line method of depreciation. Thus, much of the needed improvements in the capital cost recovery system used for regular tax purposes will, in effect, be taken away by the minimum tax. In its present form, the minimum tax would raise the cost of capital, reduce investment and harm economic growth. The solution is to use the same lives for minimum tax purposes as for regular tax purposes and to simply include the amount attributable to acceleration in the minimum tax base. The Senate proposal would also include one half of "book" income in the minimum tax base to the extent that it exceeds alternative minimum taxable income. Book income is an imprecise term which can mean accounting statements filed with the Securities and Exchange Commission, other certified financial statements used for credit or other purposes, or even unaudited statements of privately held firms generated for their own internal use. This provision will place tremendous pressure on the accountant-client relationship and the integrity of financial statements. Businesses, especially closely-held businesses, will be under financial pressure to hire accountants who tend to minimize their book income. U.S. financial accounting statements are the envy of the world. Their integrity is accepted because there is no tax-motivated manipulation of financial statements as is the case in some other countries.

Both the House and Senate bills repeal the investment tax credit retroactively to January 1 of this year. It is very hard to justify this effective date on any grounds. It is a pure revenue grab! Because businesses will have no compensating rate reductions or capital cost recovery changes, investment in 1986 has become dramatically less attractive than before tax reform. Thus, we expect investment to have already slowed in 1986 and economic growth, therefore, will be relatively sluggish for at least one year.

According to estimates by the Congressional Budget Office (CBO), the changes that we have suggested will cost, on a static basis, \$63.6 billion over a five year period. As

a result of both the uncertainty over the tax treatment of capital investment and the effective increase in taxes over this year and next, our estimate is that the rate of growth in the nation's gross national product (GNP) will be 1.7 percentage points lower over the next twelve months than it would if we immediately cut tax rates and broadened the tax base. This reduction in potential GNP will increase the federal deficit by \$7 to \$10 billion over the next twelve months alone, and even more in the future as it permanently lowers the revenue base. In contrast, the shortfall that might emerge from a speed-up in the date of enactment for tax rate reduction would be a one-time loss and would be quickly offset by the higher revenues that follow from faster economic growth. Thus, if policymakers viewed the suggested changes in their proper, dynamic sense, rather than in a naive, static sense, it would be obvious that the deficit would be lower in each of the next five years by adopting our proposed changes now.

The uncertainty surrounding taxes has already had a negative effect. Taxpayers who might be hurt by the myriad of tax reform proposals assume that they will, in fact, be hurt and, as a result, do not invest. Taxpayers who might benefit from the various proposals assume that they will not get those benefits and, as a result, also do not invest. Thus, investment and other economic activity decline. A recent survey of U.S. Chamber members found that 42 percent have delayed or canceled investment plans because of the uncertainty surrounding tax reform.

Other surveys of capital spending, both private and public, show that real investment spending this year is going to be woefully weak. If the House-Senate conference makes the recommended changes, we will have achieved tax reform that promotes long run economic growth with relatively small transitional costs.

A SEA OF CHANGE... FOR THE BETTER

by
Graciela Testa-Ortiz

The United States is firmly in the midst of twin transitions: A change in public policy objectives characterized by a general realization of the benefits of supply-side/free market economic policies, as reflected in the current tax reform debate; and, a significant shift in the economy's structure as characterized by the effect of technological in-

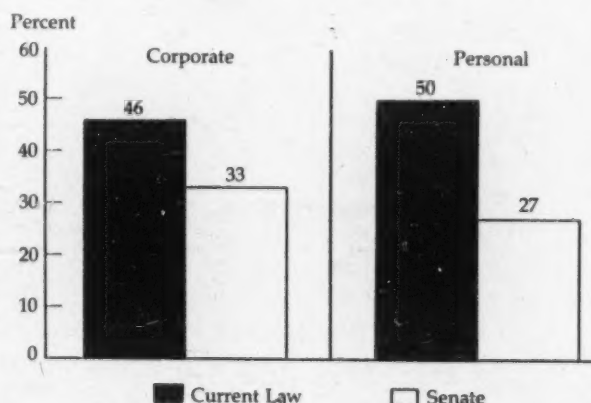
novation and world trade patterns on the production process. These developments are not unique to the United States or even to the developed economies; indeed, they have global dimensions. This article examines these two trends and their implications for U.S. public policy and the economic outlook.

The Supply-Side/Free Market Revolution Goes Global

In the past, we have stressed the importance of certain policy prescriptions which we call our "High Growth Agenda." Central to that agenda was the notion that a modest level of taxation and low marginal tax rates are a prerequisite for high rates of growth and rising living standards. Six years ago, when these supply-side policies were first introduced, they were greeted with widespread skepticism. Today, however, large segments of the academic, political and business communities agree that lower tax rates are, indeed, needed to foster stronger rates of economic growth.

Ironically, while today few economists and politicians admit to being supply-siders, they all support the essence of supply-side policies, as the competing tax reform proposals now make clear. The debate surrounding tax reform is about how these reductions in tax rates will be achieved, not about whether or not they are desirable. The desirability of tax rate reductions is no longer questioned (see Chart 1).

CHART 1
PERSONAL & CORPORATE TAX RATES

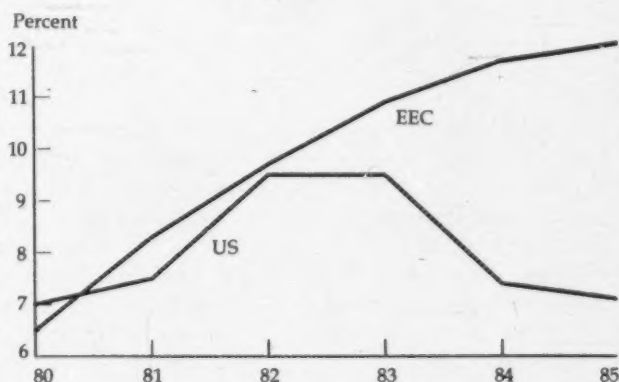


Taxes, of course, are important, but the supply-side/free market revolution goes well beyond this single focus. To insure economic vitality, low levels of taxation must go hand in hand with reductions in the level of government intrusion in the economy. The enactment of the Gramm-Rudman balanced budget act is an important step in this direction. Perhaps more than anything else, it reflects the consensus in this country that the size of the federal

government must be reduced. The absence of any new major regulations or new spending programs should be interpreted as reflecting the desire of Americans for less government. Beyond these policy issues, however, there is today a new appreciation of the free market as an engine of growth and prosperity as well as an appreciation of the general benefits accruing from capitalistic acts between consenting adults.

Americans are not the only ones who have rediscovered the wisdom of such policies. The free market policies that we have supported as a solution for the stagnation of the 1970s are now gaining wider acceptance abroad, as well. With the exception of modest changes in Great Britain, no other European nation embraced supply-side prescriptions early in the decade. Over the past several years, as the American economy created millions of private sector jobs, unemployment in Europe rose (see Chart 2) and GNP growth remained woefully weak. This weakness was often in direct proportion to how far each had drifted from free market, limited government policies. Today, most nations are slowly instituting the policies which proved to be so successful in the United States and elsewhere, and few now publicly admit to harboring socialist tendencies.

CHART 2
UNEMPLOYMENT RATES
US VS. EEC



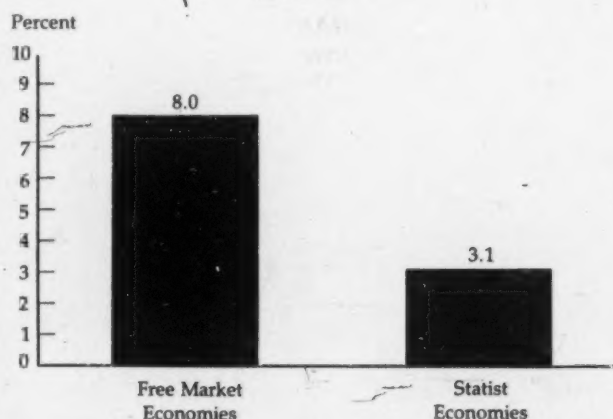
This recognition of the importance of incentives to productive activity is not confined to the developed nations or the market economies. Many of the East Asian nations, which started out the postwar era classified among the poorest nations of the world, have enjoyed dramatic increases in income and production as a result of the free market policies which they adopted.

The growing acceptance of free-market/limited government solutions to the problems of economic growth, job creation and the alleviation of poverty is particularly encouraging in the case of Latin America, a region which,

heretofore, had, almost without exception, wholeheartedly embraced the notion that the only correct development strategy was the encouragement of statist policies revolving around import-substituting industries protected behind high tariff walls. Encouraging Latin American examples of this shift in development strategies are the policies enacted by the governments of Ecuador and Bolivia.

In some respects, the postwar era can be viewed as a unique social science experiment of worldwide dimensions. As new governments were established in the early postwar era, their leaders had a variety of political/economic systems from which to choose. Some opted for socialism, others for capitalism, while still others chose a mixture, opting for significant government planning in their economies. Now, three decades later, we have their records of performance to observe and analyze. In virtually all cases, we typically find that the low tax, limited government, free market nations substantially outperformed their counterparts who elected to follow the alternative paths (see Chart 3).

CHART 3
REAL GDP GROWTH RATE
1973-1983



On the left side of Table 1, the industrial nations are ranked according to the share of income taken by the government. On the right side are the same nations

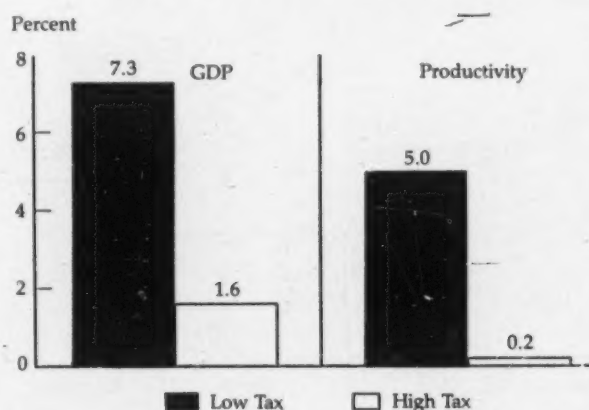
TABLE 1
TAX BURDENS AND INDUSTRIAL
PRODUCTION IN DEVELOPED COUNTRIES

Tax Burdens		Industrial Production	
	1983 Receipts as a % of GNP		Percent Change (1980-1984)
France	47.7%	Japan	16.5%
West Germany	45.2	United States	12.1
United Kingdom	42.4	United Kingdom	3.1
United States	31.7	France	0.0
Japan	29.8	West Germany	-0.7

ranked according to industrial production growth. Not surprisingly, the right side of the table shows the countries listed in exactly the inverse order of the left side of the table. This shows that the countries with lower tax burdens enjoyed the best industrial performance.

This relationship is not confined to just the industrial economies. Chart 4 is derived from a World Bank study which catalogued countries according to whether they had low or high tax rates. By both measures—GDP and labor productivity—the low tax countries significantly outperformed the high tax countries. Not coincidentally, the high tax nations are counted among the world's problem debtors.

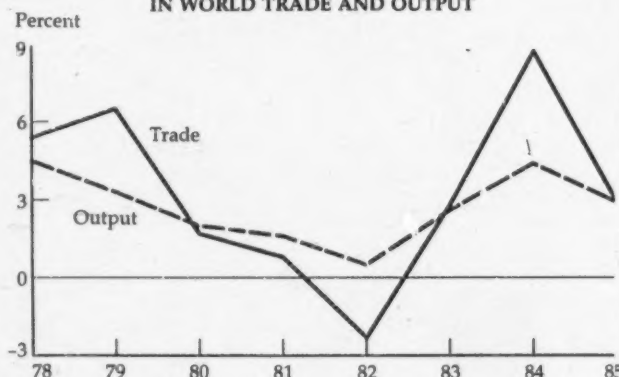
CHART 4
GDP AND PRODUCTIVITY GROWTH
IN LOW TAX AND HIGH TAX LDCs



American business should be very concerned with international growth prospects, and in particular, it should strongly support the movement toward free-market alternatives to economic development. Why? The reasons are not just altruistic, although that in itself is compelling enough. We certainly can't be complacent about an outcome where annual per capita income in Bangladesh is equivalent to the price of a tune-up and oil change of a car in the United States. But beyond these altruistic motives is self-interest. Quite simply, the developing nations represent an enormous market for U.S. exports and investment. In 1984, the developing nations, including the newly industrializing countries of East Asia, accounted for 32 percent of U.S. exports of manufactures, down from 39 percent in 1981. This demand for American products was generated in the midst of the debt crisis, when most LDCs—but particularly the Latin American LDCs—were drastically reducing imports in order to meet their debt obligations. In today's interdependent world economy, how much more important would they be, as customers, if their economies were growing instead of shrinking?

History shows us that world trade and world output generally move together, that is, when the volume of world trade is increasing, so is world output (see Chart 5). History is replete with examples of countries who have traded their way to wealth, and the East Asian countries are the most recent example. Americans should pay particular attention to this experience and resist the enactment of protectionist policies which can only harm our prospects for long term economic growth.

CHART 5
ANNUAL GROWTH RATES
IN WORLD TRADE AND OUTPUT



Shifts in the Structure of the Economy

The shifts in the economy's structure are best exemplified by the change in the relationship between industrial performance and industrial employment. In the past, these two variables moved in unison, that is, as industrial production rose, so did industrial employment. This does not appear to be the case any longer. The U.S. economy, and indeed, the world economy, is going through a period of transition which, when all is said and done, may parallel the changes brought about by the Industrial Revolution.

As we explained in our industrial outlook (see the November 1985 issue of *Economic Outlook*): "This process is by no means a negative development... An economy that can adjust successfully to changing technology, consumer tastes, and global economic conditions is a healthy, growing economy whose industries can compete effectively both at home and abroad." Decision-makers in the public as well as private sector should understand that this inevitable transition is already well underway. The future of the U.S. economy as a whole, as well as that of the individual industries and firms, depends on the implementation of the types of policies that will facilitate this process of adjustment, not delay it.

The primary mover behind these changing economic conditions is the impact of innovation and new technologies on the production process. Some worry that, as a result of these technological improvements, many

jobs will be lost in the manufacturing sector. In fact, the increase in employment in the service industries and the decline in the proportion of manufacturing in total employment is seen by some as an alarming development which implies declining living standards. They point out that high-wage manufacturing jobs are being lost while employment gains are being realized in lower wage service sector jobs.

The decline in manufacturing as a source of employment is nothing new; as Chart 6 shows, it began several decades ago. Moreover, this same trend is apparent in all industrialized countries. Increases in industrial production no longer mean concomitant increases in employment in the industrial sector. While industrial production increased by 14.7 percent between 1980 and 1985, manufacturing employment in 1985 was still 1.2 million jobs below its 1980 level.

CHART 6
MANUFACTURING EMPLOYMENT AS A PERCENT
OF TOTAL EMPLOYMENT



Is the shift toward a service-producing economy a negative development? Should public policy be geared toward preserving manufacturing jobs? The answer to both questions is no. Research by the Bureau of Labor Statistics (BLS) shows that the concern with the impact on living standards of the shift to the service sector as a source of jobs is misplaced. In particular, the evidence does not support the view of a shift from high-wage to low-wage jobs. This notion stems from the commonly held view that service sector jobs are low skilled, mainly part-time, dead-end jobs which pay little more than the legal minimum wage. This ignores the fact that the service sector includes jobs other than those found in eating and drinking establishments and retail stores. The service sector also includes firms in finance, insurance, real estate, advertising, computer services, legal services, communications and a host of other industries whose wage levels are significantly higher than the minimum wage. Before bemoaning the jobs lost to automation, one

must remember that before a robot can be installed it has to be designed, tested, and built; and once it is in operation, it requires highly-skilled people to program and service it. Beyond this, the BLS study reminds us, "we should not forget that efficiencies related to technological innovation may change the relative prices of goods and services, increase product demand, and free resources for investment or for the purchase of goods in other sectors."

Another concern raised by the shift to service-sector employment is the fear that lower productivity in this sector will reduce overall productivity in the U.S. economy. As a result of increases in capital investment, labor productivity in the manufacturing sector has risen at rates exceeding those of most earlier recovery periods. The improvement is even more impressive in durable goods manufacturing. Moreover, this has occurred in spite of the fact that capacity utilization remains relatively low. As a result, unit labor costs in the manufacturing sector actually declined during this recovery, the second time this has happened in the seven postwar recoveries. However, it is not true that productivity in the service industries is uniformly lower than in manufacturing. The BLS study points out that between 1973 and 1983, the increase in labor productivity in such service industries as telephone communications, gasoline service stations and air transportation, ranged between 3.3 percent to 6.5 percent per year. In general, the study concludes, "the range of growth rates in service-producing industries was very wide and similar to that of the goods-producing industries."

When one speaks of technological innovations, robots are the first thing that springs to mind. But the impact of new technologies is not limited to the industrial process. New technologies have revolutionized the farm economy through their impact on high-yield hybrids, fertilizers, and pest control, as well as their more traditional impact on improved farm machinery. As a result, the global supply of agricultural products now far exceeds the demand. Not long ago studies such as the *Global 2000* report to President Carter and *The Limits to Growth* by the Club of Rome, asserted that by now, the relationship would be reversed; that is, that the supply of food would not be capable of keeping pace with expanding demand.

Over the same period, most nations have engaged in substantial efforts to raise farm production. As a result, of the industrialized nations, only Japan is still a major importer of food. The developing nations have been even more successful than the U.S. or the European Community in increasing food production.

The same has happened with other basic raw materials. Technological advances have now made substitutes available for basic raw materials such as copper and steel. The substitution of plastic tubing for copper in construction, or fiberglass cable for copper wire in telecommunica-

tions, or the decline in the amount of steel necessary to produce an automobile, are prime examples. Consequently, most basic raw materials are in oversupply and commodity prices have reached historic lows. The falloff in the price of oil, in part, also reflects the impact of new technologies which have resulted in the introduction of machines, such as the heat pump or fuel-efficient automobiles, which permanently reduced the demand for petroleum. Thus, the decline in the price of commodities will not be reversed since it stems from a decline in demand which will not be reversed. For evidence, consider that despite the global economic recovery, commodity prices and the proportion of manufacturing jobs in total employment have remained low. In fact, between 1981 and 1985, U.S. demand for petroleum fell by 2 percent, in spite of the fact that real GNP increased by 11 percent and crude oil prices fell by 35 percent over the period. Moreover, manufacturing employment fell to 19.9 percent of total employment in 1985, compared to 22.8 percent in 1980, while industrial production increased.

The Twin Transitions

It is important to realize that these technological innovations, which have altered the face of the production process and have resulted in the introduction of a multitude of new products and services would not have occurred in the absence of free markets. Moreover, the increased importance of free market mechanisms, and the erosion of the fiscal and regulatory impediments to the free interplay of market forces holds the promise of a renewed unleashing of entrepreneurial vigor.

The conclusions that should be drawn from this evidence are that: (1) future increases in industrial production are unlikely to be accompanied by major improvements in industrial employment or raw material prices; (2) that this trend does not imply declining wages, productivity, or employment for the economy as a whole; (3) that, in fact, it will result in a better allocation of resources, the introduction of new products and services, and a healthier overall economy; and, (4) that public policy should not delay the process of adjustment in an attempt to preserve industrial sector jobs.

The Near Term Outlook

The economy's performance during the next two years will be shaped mainly by tax reform. While the Senate's proposal represents an improvement over the House version, it, nonetheless, contains some provisions which will burden U.S. businesses with additional taxes. In particular, the Senate tax bill will increase the taxation of capital gains and the corporate minimum tax, and repeal the investment tax credit retroactively. The timing problem is particularly important since it is likely to depress growth in 1986 and early 1987. Since the Senate bill offers improved depreciation in 1987, plus a lower tax rate, why would any business take delivery of nonessential capital equipment in 1986?

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1987
 Prepared by the U.S. Chamber of Commerce
 (Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS										YEARS		
	Actual			Forecast							Actual	Forecast	
	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	3.0	0.7	2.9	2.0	4.9	4.4	3.2	3.6	4.6	5.4	2.2	2.6	4.0
Consumption	4.6	0.1	3.8	4.7	3.5	2.2	1.8	2.0	2.9	4.4	3.3	3.2	2.6
Residential Investment	8.5	5.7	9.7	9.8	-1.9	-5.4	-5.6	-2.7	1.6	2.4	1.7	6.1	-2.3
Nonresidential Investment	2.4	11.3	-13.3	1.6	4.5	5.3	1.9	1.5	7.1	4.8	9.7	0.6	3.6
Equipment	3.0	13.5	-12.1	2.8	5.5	5.7	1.4	0.4	8.0	4.2	8.8	2.0	3.6
Structures	1.2	7.2	-15.4	-0.7	2.7	4.6	2.8	3.7	5.4	5.9	11.4	-1.9	3.6
Exports	-5.1	6.6	6.6	12.0	12.7	13.2	13.1	13.5	13.5	13.5	-3.0	6.0	13.2
Real Net Exports (\$2B) ..	-119.8	-140.8	-138.1	-129.8	-119.0	-107.4	-93.2	-78.1	-64.5	-53.3	-108.4	-123.6	-72.3
Imports	12.8	24.5	2.4	1.9	0.4	0.5	-1.3	-1.5	0.1	2.3	2.7	7.9	-0.2
Government Purchases ...	37.3	23.4	-30.1	-5.0	2.3	2.0	1.2	1.0	0.5	0.1	10.3	-1.6	0.9
Final Sales	5.0	1.3	-1.7	4.5	4.2	3.3	2.9	3.2	4.5	4.9	3.9	2.1	3.6
Change in Business Inventories (\$2B)	-1.8	-6.3	35.3	13.6	19.6	29.5	32.4	36.8	38.6	43.5	5.7	24.5	37.8
Industrial Production	3.1	2.0	2.3	-2.5	8.7	8.0	4.8	5.9	8.1	9.0	2.6	2.5	6.3
Total New Car Sales (mill.)	12.4	10.3	11.0	11.0	11.0	11.0	11.2	11.3	11.5	11.9	11.2	11.1	11.5
Domestic Car Sales (mill.)	9.4	7.0	7.9	7.8	7.9	8.1	8.3	8.3	8.5	8.9	8.3	7.9	8.5
New Housing Starts (mill.)	1.69	1.77	1.99	1.95	1.87	1.83	1.71	1.73	1.75	1.76	1.74	1.91	1.74
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.2	7.0	7.1	7.1	7.1	6.9	7.0	7.0	6.8	6.5	7.2	7.1	6.8
Compensation	3.0	3.2	2.0	2.9	3.0	3.2	4.1	3.4	3.6	3.7	3.7	2.9	3.5
Productivity	0.4	-4.1	3.5	0.0	2.8	1.9	1.1	1.6	1.9	2.1	-0.2	0.6	1.7
Unit Labor Costs	2.6	7.7	-1.4	2.9	0.2	1.2	2.9	1.7	1.6	1.5	4.3	0.7	2.0
Consumer Price Index	2.4	4.4	1.4	-2.0	2.0	2.8	2.9	2.8	2.9	2.9	3.5	1.8	2.6
Implicit GNP Deflator	2.9	3.3	2.9	1.9	2.6	2.2	2.3	2.6	2.6	2.8	3.3	2.7	2.4
Prime Interest Rate (%)	9.5	9.5	9.4	8.5	8.3	8.0	8.0	7.8	7.6	7.5	9.9	8.5	7.7
3-mos. Treasury Bill Rate (%)	7.1	7.2	7.0	6.2	6.0	5.9	5.7	5.5	5.6	5.9	7.5	6.3	5.7
Corporate Bond Rate (%) ..	11.0	10.6	9.6	9.3	9.0	8.8	8.4	8.0	8.0	7.8	11.4	9.2	8.1
Real Personal Disposable Income	-4.6	2.2	5.7	2.5	1.0	1.7	2.8	1.3	1.8	6.1	1.4	2.4	2.2
Profits from Current Production (\$B) ¹	221.7	216.0	234.0	217.2	228.6	229.7	231.7	240.1	250.0	278.5	210.5	227.4	250.1
GOVERNMENT FISCAL POLICY (\$B)²													
Unified Receipts											736	778	846.9
Unified Outlays											937	988	1013
Unified Deficit											-201	-210	-166.1
¹ After-tax corporate profits with inventory valuation and capital consumption allowances. ² Unified budget figures on a fiscal year basis.													
SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.													

FORECAST ASSUMPTIONS

This month's outlook contains the June revisions to the National Income Accounts for the first quarter of 1986. The forecast incorporates provisions of the Senate's plan for tax reform. These include: reductions in personal and corporate marginal income tax rates, repeal of the ITC, less generous depreciation allowances for structures, and elimination of the preferential treatment of capital gains income. These changes are implemented consistent with the static revenue estimates reported by the Joint Committee on Taxation. The nation's money supply (M1) is assumed to grow by 11.9 percent in 1986, 10.6 percent in 1987, and 8.4 percent in 1988. The trade weighted exchange value of the dollar falls by 9.6 percent in 1986, 5.3 percent in 1987, and 1.9 percent in 1988. The price of imported oil averages \$15.00 per barrel. The federal minimum wage is not expected to increase.

This month we have performed alternative simulations to show the negative impact of this timing problem. In 1987, individuals will lose their deductions effective January 1; but the reduction in tax rates does not go into effect until July 1, 1987. The result is that at least some individuals may actually experience a tax increase next year. We should have learned these lessons in 1981 when the individual tax rate reductions, enacted in 1981, did not go fully into effect until 1983. This delay contributed to the severity of the 1982 recession. Five years later, the pending enactment of a tax reform bill with the same type of timing problems could lead to the same results.

As a result of the potentially depressing initial effects of tax reform, we expect real GNP to rise by 2.6 percent this year. The beneficial effects of lower oil prices, which should be felt toward year-end, are likely to be offset considerably by reduced investment spending due to tax reform considerations. Growth should be somewhat stronger in 1987 as the transition to lower tax rates is completed and the economy continues to benefit from low inflation, falling interest rates, and a lower-valued dollar.

We remain optimistic with respect to the prospects for inflation. We believe that the concern regarding an acceleration of inflationary pressures stemming from rising prices in the services industries is misplaced. Empirical evidence shows that wholesale prices of raw and semi-fabricated materials, not services, are a leading indicator of future inflation. Not only are commodity prices at a historical low, but, as explained above, they are unlikely to rise substantially. This evidence, together with other factors such as still modest wage pressures, very low rates of capacity utilization, and productivity increases, provide a powerful argument for a low inflation scenario, despite the upward pressure that may stem from higher-priced imports.

Thus, barring the near-term weakness that we foresee stemming from tax reform considerations, the outlook for the American economy is, indeed, optimistic.

THE MONEY MYSTERY: SOME CLUES

by
Ronald D. Utt

Over the last year or so, the basic tenets of monetarism, which argue that there is a reasonably stable and predictable relationship between growth in the money supply and growth in nominal gross national product (GNP)

have fallen from favor as both an explanation of macroeconomic phenomena and as a guide to Federal Reserve policy. In large part this disfavor follows from an apparent breakdown in the heretofore predictable relationship between money and nominal GNP, as well as the latter's component parts: real economic activity and inflation.

Monetarists have long argued, and the historical evidence generally supports their argument, that the economy's demand for money follows a stable and predictable pattern, and that this stability enables one to predict, with reasonable certainty, the impact of a change in the money supply on nominal income, and thus, on its component parts—the price level and real economic activity. Typically, an increase in the money supply above its trend rate of growth leads to a comparable increase in nominal GNP, first through an increase in real economic activity and then through inflation, with the whole process generally taking about 24 months to run its course.

Since early 1984, however, this relationship appears to have fallen apart as the money supply (measured by M1—the sum of cash, demand deposits and NOW accounts) has continued to advance at a rapid clip while growth in real GNP and inflation have slowed substantially. At first, in late 1984, this was viewed as just a temporary aberration that would quickly rectify itself, but as the months went by, and as 1985 gave way to 1986, it became apparent that the slowing in both the economy and the rate of inflation were becoming even more pronounced while the money supply continued to increase at accelerating rates.

Beginning in late 1984, for example, growth in the money supply increased at double-digit rates and continued at those rates for all of 1985. In 1985, M1 increased by 11.9 percent and has been running at even higher rates of growth through the first part of 1986. At 11.9 percent, money growth in 1985 was the highest in the postwar era, and well above the 8 percent rates of growth in the late 1970s which contributed to the accelerating inflation and financial instability at the end of that decade. But, in 1985, such rapid rates of money growth seemingly had no apparent impact on either inflation or economic growth. Indeed, both measures actually declined from their rates of increase experienced in 1984, and have continued to slow even further in 1986. Real GNP growth in 1985 was only 2.2 percent compared to 6.5 percent the previous year, while the implicit price deflator fell to 3.3 percent from 4.1 percent in 1984. And over the same period, industrial production scarcely advanced at all.

This breakdown in the relationship between money and nominal GNP has contributed to a rather lackluster performance for the forecasting profession over the past year or so. At the outset of 1985, the consensus forecast was

for 3.3 percent real GNP growth that year, and this was increased to 3.9 percent by March. Likewise, inflation was expected to rise somewhat faster from its 1984 rate of advance. Instead, real GNP growth struggled along, while the rate of inflation slowed. As poorly as the consensus forecast was, the forecasts by monetarists were even worse. Many had predicted robust growth and rising inflation, with some estimates of the price increase going as high as 8 percent in 1985. The Chamber was not immune to this view, and, thus, actual experience fell well short of our forecast.

Obviously, there were some extenuating circumstances that can explain these inaccurate forecasts: The rising value of the dollar helped keep the economy and inflation in check, while the threat of a hostile tax bill deterred some capital investment, and the collapse of oil prices contributed to further moderation in inflation. Nonetheless, a careful review of these factors suggests that they merely contributed to trends that were already evident. Moreover, as suggested later in this article, these special factors, too, may have been the outcome rather than the contributors to the rather unusual relationship between money and everything else that emerged in recent years.

As is usually the case, the economics profession has rushed forth with a host of competing explanations for what happened since 1984. With monetarism seemingly in retreat after reaching an intellectual high-water mark at the beginning of the decade, these explanations fall into two basic schools: Those who want to drive the final nails into the coffin of M1 and its monetarist supporters, and those who want to resurrect the tenets of the discipline by attempting to interpret more accurately what happened during the last several years.

Those who have never been comfortable with the monetarist belief in a stable relationship between M1 and nominal income (which follows from a stable and predictable demand for money), see the events of the last year or two as confirmation of their skepticism and point to the sharp deceleration in the velocity of money as proof. If the demand for money were stable or changed in a stable, predictable fashion, then velocity (the ratio of GNP to M1) should be stable and predictable as well. Between the end of World War II and 1981, such stability appeared to be the rule. Velocity increased at a consistent pace year after year, reflecting steady declines in the demand for money that followed from technological changes in the financial system which allowed businesses and individuals to spend more while holding less money. Such things as sweep accounts and credit cards diminished the demand for cash and demand deposits. Since 1981, however, velocity has been declining at about 2 percent per year. This reversal of velocity growth and its duration is unprecedented in the postwar era.

A decline in velocity is, of course, equivalent to an increase in the demand for money. And with the demand for money thus subject to unpredictable changes in either direction, predictions based on changes in the money supply become problematic.

What could have disrupted what had heretofore been viewed as a highly stable relationship? Opponents of monetarism argue that the sharp decline in inflation since 1981 encouraged individuals and businesses to hold more cash and demand deposits for a given level of transactions. In the years prior to 1981, when inflation worsened year after year, successive increases in the price level led to the depreciation of money. To avoid this, businesses and individuals were encouraged to economize on cash holdings by putting more of their liquid wealth into interest-earning financial assets in an effort to limit this depreciation.

But once inflation decelerated, such defensive precautions became unnecessary and their costs outweighed their benefits. As a consequence, the economy's demand for money rose and increases in the supply were quickly absorbed by businesses and individuals anxious to increase their holdings of money in order to save on the transactions costs that are incurred in making frequent switches between money and highly liquid assets such as Treasury bills. Inasmuch as the period from 1981 to the present has been characterized by a declining rate of inflation and a diminution of inflationary expectations, this is a reasonable explanation of what has happened.

Acceptance of this explanation, then, raises very real questions about the predictive capability of monetarism and monetarists' prescriptions for Federal Reserve Policy. If money demand is not stable, then neither is the relationship between money and income. Under these circumstances, the Fed cannot have much confidence in the impact of its policies unless it finds some other economic variable in addition to M1 to guide its actions. If society wishes to hold more money and the Fed does not accommodate this change, then monetary policy will be too restrictive and the economy will suffer accordingly. Growth in income will be slow, real interest rates and the exchange rate will be high and sensitive commodity prices will decline. Inasmuch as all of these events have occurred at one point or another over the past several years, public policy officials and economists have become increasingly disenchanted with the monetarist prescription which they so willingly embraced at the beginning of the decade.

Although monetarism is in retreat, its opponents contend that vestiges of those beliefs still guide Fed and Administration policy, and that a reluctance to be free of the notion altogether has contributed to today's lackluster economy. The Fed, for example, still formally attempts to

meet M1 targets and although it has regularly exceeded them over the past several years, opponents argue that this excess has fallen well short of the increase in the demand for money. Thus, they argue that monetary growth is still too restrictive despite the double-digit rates of increase in M1 over the past year or so. These opponents further argue that the Fed should give up on M1 targeting altogether and instead attempt to stabilize commodity prices. That way it would not have to guess what the economy's demand for money was at any point in time, but would still be able to support noninflationary economic growth. If prices fell, then money would be deemed too tight and further increases in the money supply would be appropriate. If prices increased, money would be deemed too loose and some restraint would be required.

In response to these criticisms, some monetarists defend the basic principles of the discipline by noting that it is the definition of money (M1) that is the problem, not monetarism *per se*. They note that in 1981, when the divergence between M1 and nominal GNP first emerged, the definition of M1 was changed by the Federal Reserve to reflect regulatory changes that allowed depository institutions to offer interest bearing checking (NOW) accounts. The Fed assumed that the NOW accounts would be treated the same way as demand deposits and, thus, included them in their measure of M1. However, as the defenders of monetarism point out, individuals who hold NOW accounts treat them much more like a savings account than a transactions account. They note, for example that whereas demand deposits have an annual turnover rate of 434, reflecting their role as a transactions account, the turnover rate for NOW accounts is only 15 times per year, which is much closer to that of a savings account (which has never been included in M1). This distinction, they argue, is of critical importance because much of the growth in M1 over this decade has come from growth in NOW accounts. As John Paulus, Chief Economist for Morgan Stanley, has recently reported, from 1981 to the present, NOWs and super NOWs have accounted for 73 percent of the reported growth in M1.

When Paulus adjusted for this definitional change by redefining M1 simply as cash plus demand deposits, which is how it was defined until 1981, he discovered that the observed change in velocity largely disappeared. This implies, of course, that there was no shift in demand, only an "error" in definition which has misled policymakers as well as the proponents and opponents of monetarism. According to Paulus, from mid-1982 to mid-1983, for example, the growth in "new" M1, upon which most monetarist predictions were based, accelerated to 12 percent, while "old" M1, which excludes NOWs, increased by only 7 percent. Thus, monetary policy was not nearly

as stimulative as most people believed at the time. This divergence between the two measures has continued through the present, and, thus, explains some of the observed differences between monetary growth and nominal GNP over the period.

But does this explain all of it? Even after the definitional adjustments that restore M1 to its old self, there still appear to be discrepancies between changes in money and nominal income. For example, recent trends in old M1 hardly seem to suggest a tight money supply, although monetary policy as defined by old M1 was not nearly as loose as trends in new M1 would suggest. Yet, since mid-1984, the economy, prices, interest rates, and other measures do seem to be reacting to something more restrictive than the redefinition suggests.

This suggests that the truth lies somewhere in between the two contending forces—the "redefined" monetarists and their opponents. Redefining M1 does take away some of the mystery, but not all of it, while the possibility that the demand for money did shift during the early 1980s may explain the rest.

Does this imply that monetarist views have no value? Not by a long shot, but it does suggest caution in relying on mechanical rules that may occasionally be subject to exceptions whose existence may be difficult to predict or realize. History does suggest that the demand for money is generally stable, but shifts in demand do occur and such shifts may be difficult to predict or measure. Beginning early in this decade, monumental changes occurred in the economic environment. Inflation was brought under control, financial institutions were deregulated, new financial assets were developed and the tax code was substantially changed. All of these changes must have had some impact on the demand for money, and some increase in society's willingness to hold money probably did occur.

But at some point, this increased demand will be satisfied and, if price stability is maintained, the previous pattern between money, however defined, and nominal income will reemerge. This, then, suggests a note of caution to the opponents of monetarism who are now urging an even looser monetary policy than is already implied by the double-digit rates of growth in new M1. Once the "stock adjustment process" is complete and the patterns of the past reemerge, excessive growth in the money supply will begin to have an adverse effect on inflation. When this adjustment process will end is anybody's guess, but at some point it will end. The demand for transactions balances is not insatiable and some measure of caution is imperative if we are to avoid the mistakes of the past.

REGIONAL SURVEY

by
Rajni Bonnie Ohri

Now almost four years old, America's recovery from the 1982 economic downturn continues, albeit at a more moderate pace. The slide in the value of the dollar, lower oil prices and interest rates, and improvements in economic activity of our trading partners are the main factors that should help buoy growth in the national as well as regional economies. Energy-intensive, credit-sensitive and exporting industries and regions are the obvious beneficiaries of current conditions. Other regions, however, will not fare as well, and the uneven performances of major industrial sectors will be reflected in regional economic activity. Nonetheless, the overall economic environment remains relatively bright for the remainder of this year and next.

As is too often the case, the media focus has been on the bad news. In newspapers across America, headlines give us daily reports concerning the problems in agriculture, oil and related sectors, the slowdown in the computer industry, and the fluctuating performance of America's traditional manufacturing industries. This article examines regional economic performance during the past year, focusing on factors which account for the disparity in economic conditions around the nation. The analysis reveals that those regions, in particular New England and the Pacific, which have benefited the most from the strength of the expansion, share similar industrial characteristics such as a diversified industrial base and a favorable business climate. Regions which now lag behind (West North Central, West South Central and East North Central), are relatively more dependent on a few specific industries which have suffered over the past several years.

Behind these more obvious patterns are several significant trends that are certain to affect the U.S. manufacturing climate. Many states realize that they can no longer rely solely on their existing manufacturing base and are developing new information-age strategies to remain competitive. Around the country, high technology firms are sprouting up besides farms and factories. California's Silicon Valley still leads in high-tech activity, but Florida, Massachusetts, Texas and North Carolina are close on its heels.

Recognizing that the U.S. economy is now intimately integrated with the world economy, many states have regularly led missions on a worldwide search for industries to relocate within their borders. In 1985, there were 325 new foreign manufacturing investments in the U.S., with the largest number settling in New York and

California. Other states which have experienced a significant increase in foreign manufacturing investment are Washington, Georgia, Oregon, Alabama and North Carolina. In addition, more states are becoming aware that exporting is an integral part of their economic development. Indeed, over half of the states, including Oklahoma, Texas, Illinois and Nevada, now have offices in Japan and Europe to facilitate trade.

Overview

America's demographic profile reflects a continuing urge to follow the sun. Between 1980 and 1984, the fastest growing regions in terms of population growth were still the South and the West. California, Florida, Texas, and Arizona are expected to have the largest increases in population growth between 1985 and the end of the century. Significant gains in population are also expected in New England and the Midwest, with Massachusetts and Connecticut growing rapidly. Relatively small population declines are projected for the District of Columbia, West Virginia, South Dakota, Nebraska and Iowa.

As shown in Table 1, per capita personal income for the nation as a whole posted a healthy 5.3 percent nominal increase in 1985 compared to 1984. The New England, Middle Atlantic and West North Central states enjoyed above average income growth, while the slowest growing regions were the West South Central, East South Central and Mountain states. State nominal personal income per capita in 1985 ranged from \$17,756 in Alaska to \$9,035 in Mississippi, compared to a national average of \$13,451. According to the Department of Commerce, the states expected to enjoy the largest percentage increases in personal income between now and the end of the century are Arizona, Nevada and Utah. Pennsylvania, Illinois and New York are anticipated to have the smallest increases over the same period.

TABLE 1
PER CAPITA PERSONAL INCOME BY REGION
(\$ Thousands)

	1984	1985	Percent Change 1984-85
U.S. Total	\$12,772	\$13,451	5.3%
New England	14,429	15,387	6.6
Middle Atlantic	13,896	14,740	6.1
South Atlantic	12,254	12,897	5.2
East North Central	12,698	13,337	5.0
West North Central	12,532	13,296	6.1
East South Central	9,952	10,407	4.6
West South Central	11,886	12,401	4.3
Mountain	11,791	12,328	4.5
Pacific	14,030	14,751	5.1

Source: U.S. Department of Commerce, *Survey of Current Business*, April 1986.

In the year to March 1986, national retail sales increased by 3.5 percent. Regional performance ranged from a 11.1 percent increase in retail sales activity in the New England states to a decline of 2.2 percent in the West South Central states (see Table 2). The data agrees with results from the Chamber's Early Outlook Sales Survey, a nationwide compilation of retailer's expectations.

TABLE 2
RETAIL SALES BY GEOGRAPHIC AREA

Region	Percent Change March 1986 from March 1985
U.S. Total	3.5
New England	11.1
Middle Atlantic	9.2
South Atlantic	4.0
East North Central	2.6
West North Central	1.8
East South Central	2.0
West South Central	-2.2
Mountain	2.4
Pacific	1.1

Source: U.S. Department of Commerce, *Current Business Reports*, March 1986 (issued May 1986).

In April of this year, the nation's civilian unemployment rate stood at 7.1 percent, down from 7.3 percent in April 1985. As Table 3 shows, most of the regions shared in the improved employment situation. New England's jobless rate is 4.3 percent and falling fast. However, the South Central region's unemployment rate is over 9 percent. Reflecting the problems in the oil and mining industries, Louisiana, Mississippi, West Virginia and Wyoming have the highest unemployment rates in the nation. New England's diversified economy is exemplified by the fact that New Hampshire, Connecticut, and Massachusetts have enjoyed the lowest unemployment rates in the nation during the past two years. By industry, almost every

TABLE 3
CIVILIAN LABOR FORCE UNEMPLOYMENT RATE
(Percent)

Region	April '85	April '86 ^(p)	Annual Rate 1985
U.S. Average	7.3	7.1	7.3
New England	5.0	4.3	4.7
Middle Atlantic	6.6	5.9	6.4
South Atlantic	7.1	6.2	7.0
East North Central	8.9	7.8	8.6
West North Central	6.1	5.8	6.0
East South Central	9.0	9.4	9.2
West South Central	8.5	9.4	8.6
Mountain	7.5	7.9 ^(a)	7.2
Pacific	8.3	8.3	8.2

(p) Preliminary data

(a) Note: 1986 unemployment rate for Colorado not available.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

region reported job gains in trade, services and finance, insurance and real estate, and over one-third of the nation's nine census regions experienced increases in manufacturing employment. The National Planning Association ranked Los Angeles first in job-creating ability and anticipates that a total of one million new jobs will be created there by the year 2000. Boston, Anaheim, San Jose and Phoenix are all projected to experience employment increases ranging between half a million and one million jobs during the same period.

New England

Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

New England's economy should continue to exhibit robust growth this year and next. The region is banking on new businesses, venture capital and foreign investment to tide it over the slump in the computer and high-technology industries. Small firms are expected to create most of the 110,000 new jobs forecast for this year in the region; nearly half of those jobs will be in Massachusetts. Maine and Rhode Island, somewhat slower to adjust their industrial pace, will lag behind. A recent report by *INC. Magazine* cited Connecticut and Massachusetts among the top five states with the best business environment, particularly for small businesses.

Reflecting the region's strength, New England enjoys both the nation's highest per capita income and lowest unemployment rate (4.3 percent). Indeed, regional economic growth appears to be outpacing the rapid expansion of the labor force. Correspondingly, manufacturing wage levels in the region have risen by 10 percent over the last two years, compared to a 7.5 percent increase for the nation as a whole. The rise in total employment has improved consumers' real disposable income, creating greater demand for services, durable goods, and houses.

Regional employment strength is concentrated in the defense and service sectors and has offset some of the weakness in manufacturing employment. Increased defense spending is expected to keep Massachusetts unemployment down to 3.8 percent of the labor force. Last year, Massachusetts received \$7.7 billion in defense contracts, making it the fourth largest holder of defense contracts in the country, accounting for some 240,000 jobs. Companies such as Raytheon and General Electric will also receive research dollars from the Star Wars project, increasing employment substantially in the state. GTE is expected to add 1,000 employees to its rolls over the next two years. Many of these jobs will open at its Needham, Massachusetts plant as it goes to work on a \$4.3 billion communications contract for the Army. However, not all new jobs in Massachusetts will stem from defense-related industries. About 12,000 new jobs have been created in the skilled services of finance, law, advertising and insurance.

Connecticut's economy is also benefiting from increased defense contracts. Although Rhode Island's heavy manufacturing base has been hard hit by import competition, the state has been successful in attracting high-tech businesses. A boom in the service industries and overall business expansion has kept Maine's economy solid and growing. Manufacturing sector employment has not fared as well. In particular, the region's shoe industry has suffered from increased import competition. In Maine, eight shoe factories have closed in the past 18 months, with a loss of 7,600 jobs. In New Hampshire, where shoemakers employed almost 11,000 workers a decade ago, fewer than 7,000 people are at work this year.

With over a quarter of its manufacturing output in electronics, computers, instruments, nonelectrical machinery and machine tools, the region has an impressive base of products. But, most of these industries are expected to exhibit slow growth this year and next. Indeed, producers of high-tech electronics and telecommunications devices should experience growth rates of only 7 percent in 1986, half the rate achieved in recent years. However, business research services are growing rapidly, reflecting the strength of manufacturer's demand for research and development and data processing services. The region's export-oriented industries are recovering from the effect of the strong dollar, and capital goods producers are experiencing an increase in foreign orders. Rudolph Beaver Inc., a maker of surgical blades in Waltham, Massachusetts, finds that export orders are 20 percent higher now than they were a year ago.

The construction boom and the mix of industry within the states helps to explain the robust economic growth of New England. Construction of new homes is showing a tremendous increase so far this year, compared to the same period in 1985. Nevertheless, certain states such as Connecticut and Massachusetts, continue to suffer from scarce housing and spiraling housing costs. One cloud on the horizon is that growth may be constrained by labor shortages—a problem many other regions wish they were facing.

Middle Atlantic

Delaware, New Jersey, New York, Pennsylvania

Economic activity in the Middle Atlantic region increased at a slightly higher pace than national economic activity during the first quarter of 1986. The housing, retailing and banking sectors all showed significant strength, while manufacturing industries continued to lag behind. The region—with the exception of Delaware, which has maintained steady growth over the years—is in the process of reversing years of decline. Progress has been made by keying into high-growth industries and by diversifying existing industries. This diversification has led to a stabilization in population, in contrast to the declines

registered during the last ten years, and a concomitant increase in the regional labor force.

Residential construction grew by 21 percent in the region last year, fueling increases in construction employment and related industries such as stone, and clay, brick and glass. Similar to the New England region, strong pent-up demand has yet to be matched by a sufficient increase in new housing, leading to shortages and rising prices for housing throughout the region. Although the region's manufacturing sector continues its lackluster performance, the lower value of the dollar is already helping some local firms recover lost ground. Hale Fire Pump Company in Conshohocken, Pennsylvania has doubled its sales agents overseas due to an increase in foreign orders. MC Products Inc. in Hauppauge, New York, a manufacturer of water-level gauges for fire trucks, now prints its plates in several foreign languages due to a rise in European orders.

Industry analysts expect that 14,000 new jobs will be created this year in the high-tech and service industries of the New York/New Jersey area. In addition, New York's vast printing and publishing industry is expected to grow by 5 percent this year. Boosting New Jersey's economy is the fastest growing airport in the country in Newark, which has created thousands of new jobs and has already encouraged over 400 companies to relocate to the area. In addition, Merrill Lynch has created over 1,400 jobs in Princeton. Tourism, in the northeastern section of the region, is expected to increase this year as vacationers avoid foreign travel in the wake of terrorism and nuclear fallout. Delaware and New Jersey's tourist industries are thriving.

The spread of high-tech industries in eastern Pennsylvania and southern New York has helped to offset the weakness of the traditional smokestack industries. In Pennsylvania, 1985 employment losses were concentrated in manufacturing industries, including primary metals, textiles and apparel, nonelectrical machinery and transportation equipment. In January of this year, Mack Trucks, Inc. closed its assembly plant in Allentown and relocated to South Carolina, laying off 1,800 workers. In contrast, high-technology firms and electronics companies created over 2,300 jobs in 1985. An ambitious \$2 billion state government program, called Strategy 21, has been created to encourage development of scientific and advanced technology firms within the state, particularly in the area of robotics. In 1985 alone, Pennsylvania saw the creation of 20,100 jobs in four areas: services and finance, retail and wholesale trade, and construction.

Pittsburgh, still clinging to the title of America's "Most Liveable City," stands as an example of the successful transition from a smokestack economy to an information economy. The steady growth of high-tech companies as

well as the medical and banking industries, has helped the city weather a decline in steel manufacturing. Foreign and domestic companies are attracted to the city because of its stable growth, availability of local resources, and sufficient capital to help finance projects.

South Atlantic

District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, West Virginia

The South Atlantic region should fare well this year. The region's unemployment rate stands at 6.2 percent and can be expected to fall further if current economic trends continue. The mix of service-related industries in the region has provided some insulation from the employment declines that plague its manufacturing-dominated economy.

Florida and Georgia will again be the national leaders in employment, retail sales and personal income growth. Both states are benefiting from increased activity in defense-related manufacturing. Moreover, their tourism and recreational facilities are expected to exhibit robust growth this year and next. However, some manufacturing industries, including electronics machinery, food, paper and chemicals bore the brunt of import competition, declining foreign demand, and industry-specific problems. In 1985, Georgia saw remarkable employment growth, with the creation of 160,000 new jobs. The computer, telecommunications and software companies that have sprung up in Atlanta's "technology crescent" have also generated a substantial amount of employment. Thanks to its high-tech factories, Gwinnett County is the nation's fastest growing county. The city of Braselton soon will be turning out color televisions and cellular mobile telephones at the largest U.S. plant of Japanese electronics giant Mitsubishi.

Other states in the region are also outperforming the regional average. In the electronics, electrical machinery and other high-tech industries of North Carolina and Georgia, 50 foreign firms expanded their operations. Already recognized as the high-tech capital of the southeast, the Research Triangle of North Carolina produced a fifth straight year of record-breaking construction activity. The Raleigh-Durham area has witnessed the creation of 1,000 new jobs this year as a result of the location of the American Airlines hub. By 1987, Mack Trucks, Inc. plans to open a new plant in South Carolina which will employ over 1,000 workers. Companies in Virginia are snaring defense contracts, which along with tourism and services, are keeping the state's economy strong. Biotechnology, computer technology and service industries continue to boost Maryland's employment.

The economic picture for the other states in the region is mixed. The middle south is heavily dominated by older,

basic industries such as textiles, apparel, tobacco and furniture. Heavy capital spending for plant modernization in each of these industries last year not only spurred the construction sector but helped to make them more internationally competitive. In the Carolinas, which account for 60 percent of the nation's textile employment, unemployment is expected to climb as more jobs are lost this year. Last year, Manchester, Georgia lost two plants and 600 jobs. In order to stay in business, many textile firms have begun producing industrial fabrics and household goods, "geotextiles" or "geomembranes"—durable sheets of fiber and plastic increasingly used in drainage, erosion control, and construction. Now in the third decade of decline, the region's agricultural employment will fall further as tobacco farmers brace for a loss of price supports and markets; over 10 percent of the tobacco farmers are expected to go out of business in 1986.

West Virginia has the highest unemployment rate in the region (10.8 percent), with no relief in sight. The state is spending much of this year recovering from last November's flooding which wiped out an estimated one-fourth of its small businesses. Charleston, West Virginia stands to lose 2,000 jobs this year, due to layoffs at Union Carbide and the closing of two major plants—Volkswagen and FMC Corporation, a chemical company. In addition, coal mine closings have accentuated existing problems.

East North Central

Illinois, Indiana, Michigan, Ohio, Wisconsin

America's "Rust Belt" is making a comeback. While still tied to agriculture and smokestack industries, government officials and private industry leaders in the East North Central region are creating an environment conducive to new business growth. Businesses there are battling back by adapting high technology such as robotics, computer-aided engineering and automation, to the region's auto, machine tool, metal-fabricating and part-assembly industries. Indeed, the number of machines driven by computers has soared by 600 percent at Ford Motor's transmission plant in Livonia, Michigan.

Consumer-related businesses such as autos and appliances are doing well, while heavy industry and equipment manufacturers continue to face troubled times. Transportation and other machinery account for over a third of the manufacturing strength of the East North Central states, and industry output is expected to increase modestly this year. Automakers are planning to maintain sales incentives throughout the year despite the onslaught from imports. Moreover, several states are wooing foreign automakers to set up production facilities in their area. Currently, there are seven Japanese companies planning to produce autos or trucks in the U.S. Honda Motor Company's Marysville, Ohio complex now assembles Accord cars for about the same cost as in Japan.

Mazda Motor Company has completed its auto assembly plant in Flat Rock, Michigan, creating 3,500 new jobs. A Mitsubishi Motors Corporation auto manufacturing plant will also bring thousands of new jobs to Normal, Illinois next year. The expansion of these auto plants should send welcome ripples throughout the region as related industries, including auto parts, steel, chemicals and fabricated metals, benefit from the increase in auto production.

Prospects for steel manufacturing in the region have increased as mini-mills boost output and productivity levels. A rapid growth in steel service centers in recent years has secured Chicago's position as the nation's steel distribution center. The newly developed Great Lakes Industrial Center in Gary, Indiana houses 15 steel-related companies and provides employment for over 800 workers. Indiana's mills are a crucial link in the region's industrial economy, supplying steel sheets to the automotive and appliance industries and bars and plates to heavy equipment makers.

By far the strongest recovery area is Michigan, which is aggressively pursuing high-tech, streamlining its auto industry and encouraging business development in the area of robotics. Michigan now produces a third of the nation's robots. This year will see increased employment in construction and related industries due to several new projects: a paper mill renovation in Munising, a wafer-board plant near Sagola, and an Olympic training facility in Marquette. The economic benefits of the reopened White Pine copper mine and the new Quinnesec paper mill have also spread to surrounding towns.

In addition, the lower value of the dollar is slowly benefiting manufacturers throughout the region. Caterpillar Tractor of Peoria, Illinois—where 15,000 jobs hinge on the company's \$1.9 billion worth of export sales—reports that shipments of diesel engines to Europe are running 15 percent ahead of 1985. L.R. Nelson Corporation in Peoria, a lawn sprinkling systems manufacturer, is adapting its products to foreign requirements as export orders pick up. Nicolet Instruments Corp., a Wisconsin-based exporter of analytical and computer graphics equipment, has increased employment to meet the demand created by an increase in European orders. And Cincinnati Milacron Inc. expects machine tool orders to pick up by the end of this year.

East South Central

Alabama, Kentucky, Mississippi, Tennessee

At 9.4 percent of the labor force, the East South Central region's unemployment rate is one of the highest in the nation. The continuing problems in agriculture and

in the oil-related sectors, as well as the region's dependence on heavy industry are responsible for the economic weakness experienced by Alabama, Kentucky and Mississippi. While defense-related manufacturing should fuel the local economies, the recent space shuttle tragedy will affect areas dependent on the aerospace industry. The apparel and textile industries, especially in Alabama and Mississippi, have experienced a dismal year because of keen competition from imports. Nevertheless, growth should pick up this year as the decline in the value of the dollar and interest rates, and an improving international economy help the region's manufacturers increase exports, particularly sales of chemicals.

Spring Hill, Tennessee is currently benefiting from the General Motors \$3.5 billion Saturn plant and the 20,000 jobs the factory complex promises to generate. In addition, the decision of American Airlines to establish a regional hub in Nashville will result in the creation of over 1,000 jobs. The expansion of Nissan USA's \$750 million truck assembly plant in Smyrna will also increase employment opportunities in the area. More than half a billion dollars in new capital projects have been planned in the state, which will result in the creation of an estimated 14,000 jobs. Georgetown, Kentucky also received an economic boost in December when it was chosen as the site of the Toyota Motor Corporation car assembly plant which will create over 3,000 new jobs.

Last year's slowdown in such manufacturing industries as lumber, textiles and apparel has affected the economies of Mississippi and Alabama. Although the downturn was rather severe, the decline in the real value of the dollar, low interest rates and anticipated brisk export sales make prospects look brighter. Tire plants and other auto parts suppliers have been prospering due to strong auto sales. Uniroyal Tire Company announced a \$10 million expansion of its Opelika plant, which is expected to add 300 jobs to Lee County, Alabama this year. In an effort to generate more international trade, Alabama is opening business development offices in foreign countries. And, 100 foreign-owned companies from 18 countries have located in the state, bringing total foreign investment to over \$2 billion and generating about 15,000 new jobs.

Increased construction activity this year should stimulate Mississippi's lumber industry which is expected to see modest growth. The region's agricultural sector has been beset by reductions in foreign demand, low commodity prices and heavy indebtedness among farmers. The oil and gas industries also face deteriorating market conditions, depressed prices and abundant capacity. Drilling activity has been cut back dramatically as companies concentrate on servicing old contracts or holding leases. During 1985, the average number of rigs in operation fell to 29, down sharply from an average count of 80 rigs in 1981.

West South Central

Arkansas, Louisiana, Oklahoma, Texas

If any part of the nation is looking at a shifting future, it is the West South Central region. Many industries in these four states are in the throes of a fundamental structural adjustment process, similar to that being experienced by the Midwest, that seriously constrains short-term growth prospects. Growth will be slow this year as businesses that prospered with the oil boom continue to adjust to the low demand for petroleum and petroleum-related products. With total employment rising slower than population growth, the unemployment rate has increased in all four states. Louisiana's unemployment rate stands at over 13 percent, the highest in the nation.

According to estimates by the Southern Methodist University, every one dollar fall in the price of crude oil costs Texas 25,000 jobs, \$3 billion in purchasing power, and \$100 million a year in state and local tax revenue. Twenty-two percent of what the state produces is tied to energy and petrochemicals, making Texas five times more dependent on the oil and gas industry than the country as a whole. The hardest hit industries are oil extraction and oil-field equipment manufacturing where employment has fallen by 60 percent since 1981. In addition, U.S. oil and natural gas drilling activity is the lowest since 1943, with Texas leading the drilling downturn and Oklahoma and Louisiana following close behind. The strongest ripple from the oil price plunge has been seen at the large oil companies in the form of personnel cutbacks: Atlantic Richfield recently cut 2,100 workers in Dallas; Tenneco laid off 500 workers in Houston; Baker International dropped 800 workers from its Houston companies; MCO Resources cut one-third of its work force; and Texas Oil and Gas reduced its roster by 15 percent. Approximately 76,000 jobs have been lost over the past three months.

Although the energy sector will remain a drag on the Texas economy, growth in the services and high-tech sectors is likely to partially offset weakness in this sector. Most of the region's recent job growth has occurred in the "Silicon Gulch" (the Dallas-Fort Worth corridor), one of the nation's hot spots for high-tech industrial development. In addition, the government remains the aerospace industry's largest customer, accounting for over 60 percent of all new orders. As in other parts of the nation, the region's strongest performers are the defense and electronics industries. Houston remains the nation's leading supplier of agricultural chemicals, fertilizers and fuels. San Antonio has recently launched several programs to establish itself as a premier location for biotechnology research and commercial applications.

The declining energy sector in Louisiana and Oklahoma has also led to job losses in the mining, construction, and transportation industries. However, as in other states,

auto production continues at a healthy pace, partially offsetting the weakness in energy and agriculture. Nevertheless, falling oil prices will enable the energy-using industries, such as electrical and transportation equipment, paper and chemicals, to stabilize and grow moderately this year. Some large shipbuilding and aerospace firms are benefiting from Navy contracts to build troop and fleet oiler ships and other military hardware, thus increasing employment in the area.

In Arkansas, government officials have launched a \$3 million promotion campaign to attract business development to the state, primarily in the area of high tech. In general, the South Central states have been struggling to keep pace with the national economy, and this year will be no different.

West North Central

Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota

Despite its increasingly diverse industrial base, the economy of the "deflation belt" continues to face troubled times. Growing stocks of farm commodities, mounting debts, sluggish farm export demand, and falling farm asset values are sapping the economic vitality of American agriculture. Land values have been falling since 1981 and, in Iowa and Minnesota, are now 58 percent and 52 percent respectively, below the 1981 peak. Exports, an important revenue source, remain sluggish, having fallen by 18 percent in value and 12 percent in volume in fiscal 1985 over fiscal 1984. Prices of commodities produced in this region, including wheat, corn, milk, cattle, hogs and poultry, have declined drastically, some by over 30 percent. In Missouri and Kansas, where one in eight farmers holds virtually unrepayable debts, about 6 percent will leave farming this year. Negligible population growth and economic uncertainties in the agricultural and energy sectors do not bode well for regional employment and retail sales activity.

Sales by farm capital goods manufacturers are off sharply and the U.S. farm equipment industry is currently operating at about 40 percent of capacity. John Deere & Company, a farm equipment manufacturer, has reduced the workforce in its Iowa dealerships by 50 percent. Caterpillar Tractor has also laid off workers in Illinois and Iowa. Companies specializing in machinery for oil, construction, and farming equipment industries are in for a rough time this year and next. There will also be a continuing decline in the region's manufacturing industries, particularly in steel, apparel and shoes.

Those states whose economies do not depend solely on agriculture, farm machinery, meatpacking or heavy industry are performing significantly better than the

regional average. According to a study by Grant Thornton, American manufacturers ranked South Dakota as the state with the best business climate for manufacturing firms in the nation; North Dakota was ranked fifth. South Dakota led the region in job growth thanks to the vigor of its banking and high tech industries. Military spending will boost the state's economy substantially, generating employment in the B-1 bomber base under construction near Rapid City and at the new Air Force training complex near Belle Fourche. Construction, and auto and aircraft production in Kansas and Missouri provided the major impetus to those states' economies. In general, the prospects for the aerospace/defense/commercial aviation sector are the brightest among basic exporting activities. Indeed, Boeing Military Aircraft Company is creating substantial employment opportunities in the region.

Some metropolitan areas within the region are also outperforming the regional average. Council Bluffs, Iowa has embarked upon a program to finance business growth in electronics, food processing, telecommunications and warehouse distribution. So far, seven firms have relocated there, creating 285 jobs through \$9.1 million in investment. Bordeaux, Inc., an Iowa company that contracts for its labor, is one of a number of cottage-industry businesses that have sprouted in the Farm Belt. These businesses, which hire people to work at home, are providing a glimmer of hope in an otherwise depressed agricultural economy. Thanks to successful business ventures, new commercial megaprojects are under construction in St. Louis, Missouri. The Twin Cities have attracted several high-technology firms and have become a big center for health care providers, telephone companies, and financial institutions. Omaha, Nebraska has become the nation's largest telemarketing industry, including WATS Marketing of America.

Major oil companies are reevaluating exploration plans in the West North Central states. Some of them are reducing their activities by about two-thirds and decreasing employment by almost as much. Minnesota's problems are compounded by the mining depression in the Iron Range, where 15,000 jobs have been lost since 1980—a third of them in the past year. Although the outlook for the region is for slower growth, especially in the farm-belt, the general improvement in the economic climate should help the region readjust to a changed economic environment.

Mountain

*Arizona, Colorado, Idaho, Montana, Nevada,
New Mexico, Utah, Wyoming*

The Mountain region continues to be marked by divergent economic trends. Arizona, Colorado, Nevada, New Mexico, and Utah are experiencing rapid growth in

the service industries, high technology and other state-of-the-art manufacturing. Although hard-hit by the demise of the southwestern energy boom, the diversified economies of these states have more than offset the losses in the energy sector. In contrast, the more northern states of the region—Idaho, Montana, and Wyoming—remain heavily dependent on mining, forest products, and agriculture, and have been unable to shake off the effect of declining prices for these industries.

Arizona and Colorado, in particular, are deriving over one-third of their income from electronic, electrical and computer-related products, telecommunications and instrumentation. IBM Corporation, Tucson's second largest employer with about 5,500 employees, is attracting development to the city. Moreover, AiResearch, a division of Garret Corporation, is establishing its electronics operations in Tucson and is expected to create hundreds of jobs. Over 1,300 high-tech companies have relocated to Denver in recent years. However, high-technology activity (centered along the Fort Collins-Colorado Springs corridor), slowed significantly this year. Layoffs and plant closings became commonplace as the demand for computers, component parts and peripheral equipment softened.

Defense and space research firms in New Mexico, Wyoming and Arizona will be busy with new contracts this year. Consolidated Space Operations will start controlling military satellites in late 1986. The first 10 MX missiles will go into silos at Warren Air Force Base in Cheyenne, Wyoming. Research and testing of the Strategic Defense Initiative—Star Wars—promise full employment at Los Alamos National Laboratory and other scientific centers. Both Sperry and General Electric have aircraft related manufacturing operations in New Mexico, employing over 3,000 people. Hughes Aircraft Company added over 2,000 workers last year to its Tucson plant. On another front, Utah's Bionic Valley near Salt Lake City is expected to continue as a focus of research on artificial hearts.

The region's metals mining industry will continue to be battered by low prices and foreign competition. The industry also faces substantial downsizing and substitution of new and lighter materials in construction and in the production of autos and heavy equipment. In Utah, Montana and New Mexico, mining activity slowed sharply last year, the result of continued weakness in copper and uranium mining. Beker Industries Corporation plans to close its phosphate mining operations in Idaho due to weak fertilizer demand. One bright spot in the otherwise depressed mining industry is the scheduled development of a platinum and palladium mine in southern Montana which is anticipated to hire about 200 workers. Prospects for the copper industry may also start to pick up. The Japanese are scouring the world for copper concentrates for which there is a relatively high industrial demand.

Last year, the Sumitomo group took a 15 percent stake in America's biggest mine, Phelps Dodge's Morceni mine in Arizona.

Farmers and ranchers in the region have suffered not only from low agricultural prices and falling land values, but also from an extended drought and crop losses of \$188 million in 1985. Of the roughly 5,500 cattle ranchers in Wyoming about a quarter are facing foreclosure. A further source of distress is the federal program to reduce dairy surpluses by slaughtering nearly 1.6 million cows, thus depressing beef prices even further. Although the outlook for the region is for slower growth, it should be more manageable and more likely to guarantee healthy economies in the future.

Pacific

Alaska, California, Hawaii, Oregon, Washington

The economies of the Pacific region are banking on continued growth in the electronics, aerospace and defense industries. As in the Mountain states, the Pacific also depends on agriculture, energy, forestry and mining. The results of this diversified industrial makeup are instantly apparent: The Pacific states have the highest job creation rate in the nation and the second highest rate of population growth. The National Planning Association ranked Los Angeles first in job expansion in the nation, anticipating that by the year 2000, the city will have created a total of one million new jobs.

The region's strongest growth industries continue to be aerospace and defense. The non-defense electronics industry, which exhibited strong growth in 1984, stagnated in 1985, primarily due to a slump in semiconductor activity. Weakness in this industry is due to decelerating sales of microcomputers, intensified Japanese competition, as well as a severe inventory imbalance caused by stockpiling and overproduction. This weakness has been reflected in widespread layoffs, reduced work weeks and plant shutdowns throughout the region. Indeed, Hewlett Packard recently offered 1,800 employees early retirement plans due to the slowdown in the computer industry. In California's Silicon Valley over five percent of the jobs in electronics manufacturing were lost in 1985. After phenomenal growth rates of over 20 percent per year, it is hardly surprising to see the pace of the electronics industry slow down.

In Oregon and Washington, major efforts to lure new business into the state, especially high-tech oriented ones, have been successful. Several Japanese electronic firms have announced their decision to locate in the "Silicon Forest" on the outskirts of Portland. Washington's economy has been bolstered by defense and aircraft orders pouring in for the 83,000 workers of Boeing, the state's largest employer. RCA-Sharp recently opened a

plant at Camas, creating substantial employment in the area. The Port of Tacoma has emerged as a major intermodal shipping center, revitalizing the U.S. maritime industry and attracting such shipping firms as Sea-land and Maersk.

Foreign competition, high interest rates, chronic overcapacity and moves by some timber giants, such as Georgia Pacific, into the lower-cost South, have left the timber industry in disarray. As a consequence, mills have shut down and timberland values have plummeted. On June 16, a strike against the Weyerhaeuser Company by 8,000 woodworkers shut down sawmills in Oregon and Washington. Some 48,000 lumbering jobs and millions of dollars have been lost in Idaho, Oregon and Washington since 1980.

However, recent signs are encouraging for the timber industry as price indices for various forest products are rising and demand for new housing remains healthy. Indeed, according to the American Paper Institute, exports of wood pulp were up 50 percent since January of this year from the same period in 1985 due to the fall in the value of the dollar. Louisiana Pacific recently agreed to lease a waferboard mill near Klamath Falls, Oregon, providing substantial employment in the area.

As in other regions, farmers are grappling with low product prices, soft foreign demand, declining land values and heavy debt burdens. Particularly hard hit by these problems have been California's specialty crops, notably grapes. The tourism industry should experience another year of strong growth in 1986, especially in Alaska, California and Hawaii. Washington hopes to get spillover business from the four million people expected to visit the Vancouver World's Fair in British Columbia. Growth should remain strong in the region, as the reduced value of the dollar, together with industry shake-outs, cause the agriculture, forest products and electronics industries to stabilize next year.

GRAMM-RUDMAN-HOLLINGS AND THE FEDERAL BUDGET: AN ASSESSMENT AND OUTLOOK

*by
Cesar V. Conda**

With all the euphoria and hoopla surrounding the Senate Finance Committee's historic tax reform bill, Congress and the public seem to have forgotten about the

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federal budget, which is now in the process of being put together for the next fiscal year. To date, the House-Senate budget conference has proceeded with little fanfare. The budget process deadlines established by the Gramm-Rudman-Hollings Act (G-R-H) have come and gone without much concern being expressed about them.

The budget's "disappearance" may also be due to the fact that G-R-H is perceived to have worked. Interest rates have dropped, federal spending growth has slowed and the deficit is projected to shrink. As the situation now stands, the budget question will not be resolved until late this summer, when the end of the current fiscal year will precipitate a funding crisis.

But several developments along the way will propel the federal budget back to the top of Congress' policy agenda. The Supreme Court is expected to decide in July on the constitutionality of the G-R-H's automatic sequestering mechanism. On August 1, the Senate is scheduled to begin floor consideration on the bill to raise the public debt ceiling. On August 15, the CBO (Congressional Budget Office) and OMB (Office of Management and Budget) will make their joint estimate of the fiscal 1987 deficit to determine whether or not a sequester will be triggered.

As has so often been the case, the fundamental economic and political dispute over the issue of tax increases to reduce the deficit lies behind the budget impasse. The President remains vehemently opposed to raising taxes, while Congress claims that a tax hike is necessary to meet the G-R-H deficit ceilings. Meanwhile, the threat of an across-the-board sequester which would slash both defense and several domestic programs may force an unwise compromise on taxes.

This article seeks to assess the impact of the Gramm-Rudman-Hollings Act, and to examine the possible outcomes of this year's budget battle.

The Impact Of The Gramm-Rudman-Hollings Act

The emergence of the Gramm-Rudman-Hollings Act stems directly from Congress's failure to control the growth of federal spending. In recent years, it had become clear that the federal budget process did not work. Federal expenditures rose 17.8 percent, in inflation-adjusted terms, during the first Reagan term and 7.4 percent in FY 1985. Recognizing that new rules were required, G-R-H was designed to provide a much needed framework to reduce deficit spending over the next five years. The Act mandated fixed ceilings on the annual federal budget deficit, reformed the budget process to enhance the likelihood that Congress will abide by the annual deficit ceilings, and created an action-forcing mechanism, commonly referred to as "sequestration," which would reduce outlays by formula should Congress fail to reach

the mandated deficit ceilings on its own. In the event of a sequester, nonexempt federal spending programs would be reduced by a uniform percentage with the total burden of the reductions being borne equally between defense and certain domestic programs.

The track record to date shows that G-R-H has had both positive and negative effects. On the positive side, G-R-H has resulted in real reductions in federal spending. On March 1, the sequestering mechanism slashed \$11.7 billion from the FY 1986 budget. In an effort to ease the task of complying with next year's deficit ceiling, Congress resurrected and approved the reconciliation bill left over from 1985. This action saved another \$11.5 billion. Overall, the Act has discouraged members of Congress from proposing new and costly spending programs.

The latest U.S. Treasury budget figures show that spending growth has slowed considerably. Total outlays are 4.9 percent higher through the first half of 1986 compared to the same period last year. For the full fiscal year, the Treasury Department estimates that outlays will rise by only 3.7 percent. This is in stark contrast to the 11.1 percent spending explosion in 1985.

A closer look at the components of federal spending in fiscal year 1986 shows that several budget accounts are actually lower through the first half of this year compared to the same period last year. For example, spending for domestic budget accounts, such as Energy, Housing and Urban Development, Interior, General Revenue Sharing, Small Business Administration and several independent agencies, declined this year. Most other domestic accounts remained at last year's funding levels. Overall, domestic spending is 3.3 percent lower than last year. As has been the case in recent years, this year's spending growth has been driven by defense, entitlements, farm support, and interest on the national debt. These budget components posted increases of 9.9 percent, 5.4 percent, 36.3 percent and 9.9 percent, respectively.

The Act has imposed fiscal discipline in the budget process. However, G-R-H has its limitations. The Senate's recent action on the 1986 supplemental spending bill, which makes up for unexpected shortfalls, shows that Congress is likely to waive the Act's requirements to appease powerful special interest constituencies. The Act's deficit neutral requirement, which requires that any new spending increases be offset with decreases elsewhere, was waived twice to provide new funding authority for the Rural Electrification Administration (REA) and the Farmers' Home Administration (FHA) programs both of which benefit the powerful rural lobby.

Another limitation of the Act is the premium it places on achieving immediate savings at the expense of aggravating the deficit in the out-years. For example, the REA provision to refinance the revolving fund's high in-

terest loans leads to a \$300 million outlay decrease in 1986. However, CBO estimates that the total cost to the Treasury in foregone interest and penalties will eventually reach \$2.4 billion.

The Act's major drawback is that it could contribute to efforts to raise taxes. This is because the Act institutionalizes deficit reduction rather than spending reduction per se. In a purely static framework, taxes can be increased to help meet the annual deficit ceiling and, thus, a tax hike is always a viable option. But in reality, the negative effects of increased taxation on economic activity result in less revenue collected than predicted on a static basis. Therefore, the deficit ceilings cannot be met with tax increases.

Nevertheless, both the House and Senate versions of the budget resolution call for \$13.2 billion in "unspecified" tax increases for FY 1987 and \$45 billion over the next three years. Both versions cut defense spending well below the President's original request for \$320 billion in new spending authority and avoid deep reductions in entitlement and domestic discretionary spending.

It must be pointed out that while defense spending shares some of the blame for the increase in total spending in recent years, non-defense spending, which includes entitlement and domestic discretionary spending, is responsible for the underlying growth in the federal budget over the past two decades. Defense spending now reaches about 6 percent of GNP, compared to an average of 9.8 percent in the 1950s and 1960s, while non-defense spending today accounts for 17 percent of total outlays compared to 9.4 percent in the 1950s and 1960s.

However, in an election year, the defense budget is the sacrificial lamb. The Senate and House defense budgets propose \$301 billion and \$285 billion, respectively, in new spending authority for FY 1987. Congress is using G-R-H to hold the defense budget hostage in exchange for the President's blessing on new taxes. They argue that new taxes are necessary to meet the G-R-H deficit ceiling because domestic spending has been "cut to the bone." Despite this rhetoric of suffering, the fact is that the spending reductions required to meet the ceiling would total a mere 4 percent of the federal budget.

To the surprise of some, the fight for higher taxes has a bipartisan flavor and has the support of many of the Senate Republicans on the budget panel. In large part, this revolt among Senate Republicans is a backlash to the Administration's decision to abandon support for the Senate's courageous budget resolution last year, which proposed to freeze Social Security cost-of-living adjustments, terminate 15 programs and chop \$55 billion from the deficit without raising taxes.

Senate Budget Committee Chairman Pete Domenici has repeatedly warned the White House that without new taxes, the sequester will trigger a \$17 billion reduction

from the \$285 billion defense budget set by the House. In an effort to force the President's hand, the Senate Republicans have devised an unusual scheme that would condition the size of the defense budget on revenue increases. Under the Senate proposal, new defense and domestic funding could not occur until legislation was approved to raise revenue levels \$7.3 billion above those proposed by the President. In other words, bills providing for increased defense spending would not be sent to the President until he signed the revenue raising bill. According to Domenici, this would tie defense and taxes together "so they would flow simultaneously or not at all." The House Democrats say that they will not go along with the idea unless the President takes the lead on new taxes.

These efforts to force the President to accept tax increases have only strengthened his resolve. In a recent press conference, Reagan said, "I'll say it as often as it takes—I'll veto any tax hike that comes across my desk." Apparently, the House Democrats are believers. They have put together a tentative version of the House budget that would exclude revenues above what the President requested in his FY 1987 budget.

The Budget Can Be Salvaged

Contrary to conventional wisdom, the President and the anti-tax proponents in Congress, mainly the House Republicans, can salvage the FY 1987 budget and meet the G-R-H targets *without raising new taxes*.

Most budget process participants, including OMB director Jim Miller, expect the Supreme Court to uphold the lower court's decision and rule against the G-R-H sequester. The Court is expected to rule that the Comptroller General's involvement in the Presidential sequester process is a violation of the constitutional separation of powers. The fallback mechanism would require Congress to approve the across-the-board cuts by joint resolution and send the resolution to the President for his signature. But this mechanism threatens to be ineffectual because independent action by the House, the Senate, or the President would nullify the entire sequestering process.

Moreover, preliminary estimates of the size of the sequester and its ramifications for defense and domestic spending indicate that the Congress and the President are unlikely to approve the sequester. Under CBO's economic and budget assumptions made in February, the G-R-H sequester would indiscriminately cut spending by \$16.6 billion. According to CBO chief Rudolph Penner, a \$16.6 billion sequester would result in a 4.5 percent reduction in defense programs and a 5.7 percent reduction in non-exempt domestic programs. Defense personnel levels would be severely cut back with a reduction of 350,000 or more active and reserve personnel. Non-defense programs would be subject to real reductions because, assuming no fiscal appropriations bills are enacted, there will be no programmatic adjustments for inflation next year.

In the likely event that the sequester is rejected, the President would have the upper hand in shaping the budget because defense would not be held hostage to new revenues. As one approach, the President can pursue an active veto strategy in the appropriations process. While Reagan has been reluctant to do this in the past, the G-R-H framework provides him with the political justification to employ the veto more often. The President can argue that he is only forcing Congress to abide by the deficit mandates that they set for themselves. The veto can be an effective weapon in controlling spending because it requires a two-thirds vote of Congress to override. But the Administration may be reluctant to pursue this strategy because the political repercussions of deep cuts in popular domestic programs may jeopardize Republicans, particularly in the Senate, seeking reelection in November.

Another strategy being discussed is to use the projected revenue "windfall" in the Senate's tax reform bill. This bill leads wide annual revenue fluctuations over the next five years. CBO estimates that it would reduce the budget deficit by \$7.4 billion in FY 1986 and \$22.4 billion in FY 1987. However, the bill then would add to the deficit by \$21.2 billion in FY 1988, \$21.5 billion in FY 1989, and \$800 million in FY 1990. In other words, this strategy merely postpones the problem until 1988.

Nonetheless, if the FY 1987 tax reform revenue windfall is combined with the minor spending reductions in the budget resolution, the FY 1987 deficit would be \$134.7 billion—substantially below the FY 1987 G-R-H deficit target of \$144 billion. Senate Majority Leader Bob Dole has expressed some interest in this approach, but Senator Domenici is vehemently opposed to it. He warns that using the early revenue surpluses for deficit reduction would aggravate the deficit problem in the out-years.

The vote to raise the public debt ceiling to \$2.3 trillion offers perhaps the best opportunity to salvage the federal budget. Last year, Senators Phil Gramm (R-TX), Warren Rudman (R-NH), and Ernest Hollings (D-SC) used the debt ceiling bill as a vehicle to pass the G-R-H bill. This year, the three principle sponsors may use the debt ceiling bill as a vehicle to repair the sequester process. They plan to modify the sequester process by making the Comptroller General solely accountable to the President and, thus, avoiding the constitutional separation-of-powers problem. Other possible amendments to the debt ceiling bill include the mechanisms that would restore Presidential budgetary power such as the line-item veto and the "enhanced" rescission authority. Another strategy would be to attach a \$38.8 billion spending reduction package as an amendment to the debt ceiling bill. This debt ceiling strategy provides fiscal conservatives with the opportunity to force Congress to accept fiscally responsible measures. The public views G-R-H as a congressional promise to cut deficit spending and, thus, raising the

public debt without fixing G-R-H or complying with the deficit mandates may be politically damaging in an election year.

Conclusion

The Gramm-Rudman-Hollings Act has had a substantial impact on reducing the real growth of federal expenditures. The major drawback of the Act is the increased pressure for raising taxes to meet the annual deficit targets. The standoff between the Administration and Congress on defense and taxes will probably drag on throughout the summer and climax in an omnibus continuing resolution this fall. The interplay of the Supreme Court's decision on the sequester, an active veto strategy by the President, revenue windfall from tax reform and amendments to the debt ceiling bill may provide the Administration and Congress with the opportunity to reduce the deficit without raising new taxes this year. However, both defense and domestic spending will be reduced. The fiscal year 1987 deficit may not turn out to be \$144 billion when CBO and OMB make their final estimates, but federal spending growth should remain in check.

Next year, the budget arithmetic becomes even more difficult as Congress faces the task of reducing the deficit to \$108 billion. There will be limited opportunities to achieve further spending cuts if Social Security, Medicare and other entitlement spending is again deemed untouchable. The Administration will argue that the defense budget will have been reduced in real terms for two consecutive years while Congress will claim that domestic programs have been pared to the bone. This could add up to a big tax increase. That's why the privatization option—shifting the provision of government programs and services to the private sector—may be the only solution to shrinking the budget deficit without jeopardizing economic growth.

TRENDS IN COMMERCE NOTES ON TABLE II JUNE/JULY 1986

by
Martin Lefkowitz*

Gross National Product (GNP)—The revised estimate of Gross National Product—the total value of goods and services produced—shows that first quarter real (inflation-adjusted) GNP rose at an annual rate of 2.9 percent, more than four times the growth rate for the fourth quarter of 1985. Consumer spending, which had dragged down the

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fourth quarter performance, rebounded in the first quarter growing at a 3.8 percent rate. However, a lower rate of fixed investment was reported in the first quarter as a result of cutbacks in the energy industry. Exports increased by \$5.8 billion, while imports rose by only \$3 billion.

The Services Sector—Employment in service sector establishments increased by 199,000 jobs in May and is now 2.6 million jobs above its year-ago level. This compares with an increase of 39,000 jobs in the goods-producing sector during the last year. Over 98 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.5 percent in May. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 22.8 billion in May, an increase of 9.7 percent from its year-ago level. For the first five months of 1986, domestic passenger traffic on U.S. scheduled airlines was up 9.1 percent from the same period a year ago. International passenger traffic collapsed in the wake of fears of terrorism, experiencing a 14.8 percent decline in May compared to May of last year.

Money Supply—The nation's money supply—as measured by M1, currency in circulation plus demand deposits—increased by 1.9 percent in May and was nearly 14 percent above its year-ago level. This is considerably above the Fed's target range of three to eight percent.

Employment—The civilian unemployment rate inched up 0.2 percentage points in May to 7.3 percent, the same level as in May of 1985. The rise in the unemployment rate was due to a strong increase in the labor force for the month, (430,000 new entrants). The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 149,000 in May. Civilian employment—as measured by the monthly survey of households—increased by 218,000 persons and now stands at 109.1 million jobs (after seasonal adjustment).

Prices—The Consumer Price Index for all urban consumers (CPI-U) increased by 0.2 percent in May following three consecutive months of declining prices. The string of three monthly decreases resulted in the largest decline in the CPI in the last 37 years. The consumer price index is now only 1.6 percent above its year-ago level. The change in the the direction of the index was due to a 2.5 percent increase in gasoline prices, following three months of decreases during which gasoline prices dropped by 26.5 percent. Excluding energy, the CPI-U actually increased by only 0.2 percent in May, compared to a 0.4 percent increase in April. This indicates that the decline in energy prices are working their way into other sectors of the economy. If energy prices remain at current

levels, we should see stable prices during the months ahead.

Wholesale prices of finished goods increased in May for the first time in 1986. In contrast, for the first four months of the year, finished goods prices declined an average of one percent per month—an annual rate of 12 percent. Most of the upturn in finished goods prices was due to an increase in energy goods and food prices. However, prices of energy goods at the intermediate level of processing continued to decline in May.

Crude goods prices increased 2.3 percent in May. However, all major categories of crude goods were significantly below their levels of a year ago, except for construction materials. The largest decline in the crude goods category was in crude petroleum which registered a 51.6 percent price drop compared to its year-ago level.

Housing Starts—Privately owned housing units were started at a seasonally adjusted annual rate of 1,888,000 in May, a decrease of 7.4 percent from the April level. Housing starts were 12 percent above the May 1985 level, and in the first five months of the year were 9 percent higher than the comparable period in 1985. Building permits, an indicator of future activity in the home building industry, were down five percent for the month.

Corporate Cash Flow and Profits—Corporate profits have been sluggish for the past year. Profits decreased by 5 percent between the first quarter of 1985 and the first quarter of 1986. Economic profits, which takes into account economic depreciation and adjusts for changes in inventory valuation, were up 11.4 percent for the quarter from their year-ago level. However, corporate cash flow, which includes depreciation allowances, increased nearly 9.1 percent over that same period, indicating a strong cash position in the corporate sector.

Industrial Production—Industrial production decreased by 0.6 percent in May, following a 0.4 percent increase in April. The drop in output was widespread, with the most significant declines in oil and gas well drilling materials, and autos and business equipment. The total index was two percent below the level of January and only 0.1 percent above a year ago.

The capacity utilization rate in manufacturing decreased to 78.8 percent in May from 79.2 percent in April. The decline was attributable to a significant drop in auto production where the operating rate for the industry fell from 80.4 percent in April to 75.0 percent in May. Capacity utilization in both electrical and nonelectrical machinery dropped below 70 percent in May.

Productivity—Nonfarm business productivity increased at a seasonally adjusted annual rate of 3.6 percent in the first quarter of 1986. This was the result of a 4.5 percent increase in output, and a 0.9 percent increase in hours worked. Manufacturing productivity rose at a 2.2 percent

TABLE II
TRENDS IN COMMERCE

		Current Period	Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Mar/86	240.7	240.6	238.5	0.0	0.9
Gross National Product (\$B)	1/86	4,115.7	4,059.3	3,917.5	1.3	5.0
Gross National Product (82\$B)	1/86	3,619.9	3,590.8	3,547.8	0.7	1.9
Money Supply (M1) (\$B)	May/86	658.4	646.1	582.5	1.9	13.6
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures (\$B)	May/86	2,710.7	2,685.5	2,575.5	0.9	5.2
Personal Consumption Expenditures (82\$B)	Apr/86	2,376.8	2,364.5	2,292.3	0.5	3.6
Disposable Personal Income (\$B)	May/86	2,937.6	2,943.5	2,857.5	-0.2	2.8
Disposable Personal Income (82\$)	Apr/86	2,605.2	2,568.6	2,530.9	1.4	2.9
Personal Savings Rate (%)	May/86	4.2	5.3	6.8	-1.1[b]	-2.6[b]
Civilian Employment (millions)	May/86	108.8	108.6	107.0	0.1[c]	1.6[c]
Civilian Unemployment Rate (%)	May/86	7.3	7.1	7.3	0.2[b]	0.0[b]
Average Hourly Earnings	May/86	\$8.74	\$8.71	\$8.52	0.3	2.6
Consumer Price Index (All Urban, 67=100) [a]	May/86	326.3	325.3	321.2	0.3	1.5
Purchasing Power of the Dollar (67=\$1.00) [a]	Apr/86	0.307	0.307	0.315	0.0	-2.5
Prime Interest Rate (%) June 18, 1986		8.5	9.0	10.0	-0.5[b]	-1.5[b]
Retail Sales (\$B)	May/86	117.1	117.1	114.0	0.0	2.7
SERVICES SECTOR						
Employment in Services (Millions)	Mar/86	74.7	74.4	71.9	0.4	1.4
Consumer Purchases of Service (\$B)	May/86	1,393.8	1,386.5	1,296.8	0.5	7.4
Consumer Purchases of Service (82\$B)	Apr/86	1,147.7	1,146.5	1,112.0	0.1	3.1
Domestic Revenue Passenger Mileage Flown						
Major Airlines (Billions) [a]	May/86	22.8	21.9	20.8	-6.2	9.7
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow (\$B)						
Before Tax	1/86	216.6	233.8	228.0	-7.3	-5.0
Profits Tax Liability	1/86	79.7	87.1	83.4	-8.4	-4.4
Tax Liability as a Percent of Profits	1/86	36.7	37.2	36.5	-15.7[b]	-9.4[b]
After Tax	1/86	137.0	146.7	140.6	-6.6	-2.5
Net Cash Flow	1/86	405.6	415.8	371.6	-2.4	9.1
Industrial Production (77=100)	May/86	124.2	125.0	124.1	-0.6	0.1
Capacity Utilization Rate (Mfg.) (%)	May/86	78.8	79.4	80.3	-0.5[b]	-1.5
New Housing Starts (thou. units)	May/86	1,888.0	2,039.0	1,684.0	-7.4	11.6
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	1/86	170.3	170.9	165.3	-0.4	3.0
Unit Nonlabor Costs (nonfarm) (77=100)	1/86	161.9	157.7	158.8	-2.7	2.0
Producer Price Indices (67=100) [d]						
Crude Materials	May/86	272.8	278.9	318.9	2.3	-5.5
Intermediate Goods	May/86	306.8	307.0	319.5	-0.2	-0.7
Finished Goods	May/86	289.0	286.9	292.1	0.8	1.4
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Apr/86	593.2	596.7	598.5	-0.6	-0.9
Federal Gov't Gross Debt Outstanding (\$B) [a]	Feb/86	1,983.4	1,966.8	1,702.8	0.8	16.5
INTERNATIONAL TRADE						
Exports of Goods & Services (\$B)	1/86	377.4	367.8	379.6	2.6	-0.6
Imports of Goods & Services (\$B)	1/86	477.2	481.2	421.9	-0.8	13.2
Balance on Goods & Services (\$B)	1/86	-99.8	-113.4	-42.3	12.3	135.9
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Apr/86	179.2	176.6	166.7	1.5	7.4

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted.

[c] January data is a new series that is not comparable to previous data.

[b] Percentage point difference.

[d] Index number not seasonally adjusted, percent change seasonally adjusted.

annual rate in the first quarter, and manufacturing output rose by 2.3 percent, while hours worked increased by 0.1 percent.

Interest Rates—The prime interest rate was reduced from 9 to 8.5 percent on April 21, 1.5 percentage points below its level of last year. The prime lending rate is now at the lowest it has been since August 1978 and 13 points below the 21.5 percent peak reached in December 1980. Three- and six-month Treasury bill rates were both near 6.1 percent on June 18 after falling below the six percent range in mid-April. Thirty-year Treasury bonds which had traded at about 7.4 percent in mid-April bounced back up to 7.8 percent at the end of May, but have since fallen to 7.4 percent.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, declined to 593.2 in April (1967=100), a 0.6 percent decrease from the previous month and 0.9 percent below the level of April 1985. Federal receipts for the first seven months of fiscal year 1986 increased by 3.1 percent, while expenditures for the same period rose by 3.8 percent. The federal deficit for the first seven months of fiscal year 1986 was \$126.4 billion compared to \$118.6 billion during the same period in fiscal year 1985.

Personal Savings—The personal savings rate was 4.2 percent of after-tax income in May, lower than the 5.3 percent saving rate in April, and 6.8 percent saving rate in May of 1985. The low rate of personal savings has been attributed to a number of factors, including the rising stock market that has swelled household balance sheets and left persons with less of a perceived need to save as much from their current income.

Retail Sales—Retail sales were virtually unchanged in May following a revised 0.4 percent increase in April. Sales were 2.7 percent above their year-ago level. The May decline was due to lower gasoline prices, which pushed gas station sales down by 2 percent for the month, and more than 9 percent since March. Retail sales have been virtually unchanged since December and are still below the peak reached in September of 1985. Reflecting strong housing activity, May retail sales were strongest in the furniture, home furnishings and equipment stores.

Trade Deficit—On a goods and services basis, the trade deficit in the first quarter of 1986 was \$99.8 billion, significantly below the \$113 billion reported in the fourth quarter of 1985. The drop in the trade deficit in the first quarter was due to lower oil prices.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, jumped 1.5 percent in April, the best single month performance since October, 1983. Seven of the 11 indicators available were up, three were

down, and one was unchanged. The contributors to the April increase in the leading indicators were money supply, change in credit outstanding, manufacturers new orders for consumer goods and materials, stock prices, net business formations, initial claims for unemployment and insurance contracts, orders for plant and equipment, stock prices, money supply, net business formations and slower deliveries by vendors, indicating a backlog of orders.

FOREIGN DIRECT INVESTMENT RISES IN U.S.

A recent report by the Department of Commerce found that foreign direct investment in the U.S. grew 11.2 percent in 1985, compared with a 20 percent increase in 1984. The slowdown reflected slower economic growth and the drop in U.S. interest rates.

Foreign direct investment rose to \$182.95 billion last year from \$164.58 billion in 1984. At the same time, the depreciation of the dollar against most major currencies helped cause U.S. direct investment abroad to rise 9.2 percent in 1985, after advancing 2.8 percent in 1984. The Department of Commerce defines direct investment as the book value of an investor's equity in, and net outstanding loans to, a foreign affiliate.

HOW POOR IS POOR?

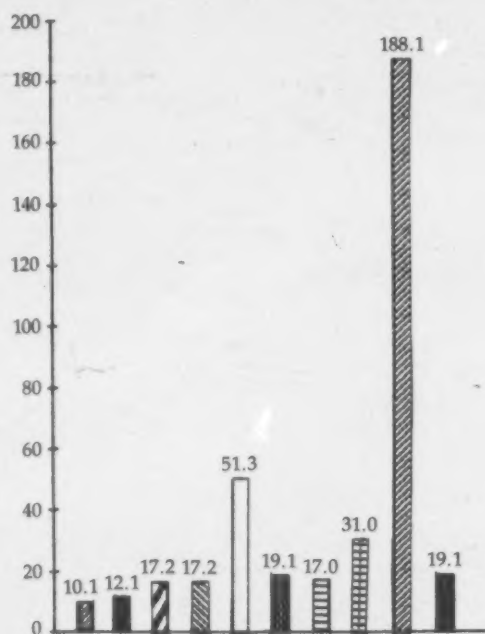
The Census Bureau has calculated the estimated new poverty thresholds for 1985, which measures how many people fell below the government's official poverty line last year. In 1984, 14.4 percent of the population, or 33.7 million people, were below the poverty line. The estimated poverty lines for families of different sizes in 1985 were about 3.6 percent higher than in 1984.

Families and persons are classified as living in poverty if their cash income falls below the official poverty line. Noncash income, such as food stamps, medical services and school lunches, is not counted.

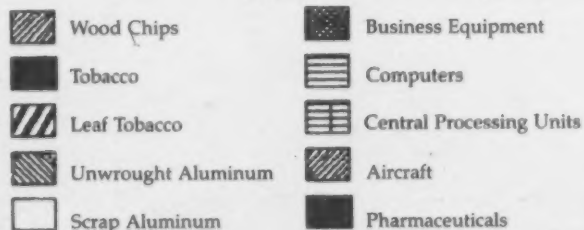
The 1985 Poverty Cutoffs Were Estimated as Follows:

One person under age 65:	\$5,590
One person age 65 or over:	\$5,160
Two persons, head of household under 65:	\$7,230
Two persons, head of household 65 or over:	\$6,510
Three persons:	\$8,570
Four persons:	\$10,990
Five persons:	\$13,010
Six persons:	\$14,710
Seven persons:	\$16,670
Eight persons:	\$18,600
Nine or more persons:	\$22,010

MAJOR INCREASES IN U.S. EXPORTS TO JAPAN January-October 1985¹

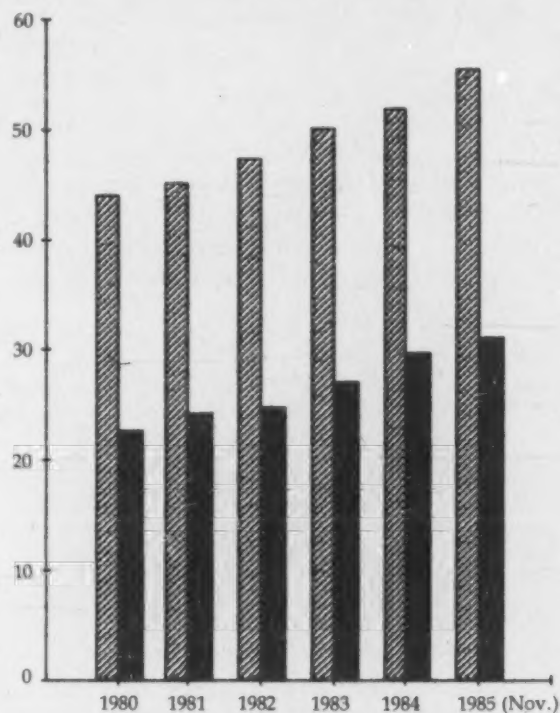


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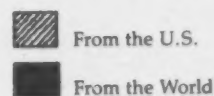


¹ Percentage increase over same period previous year.
Source: Look Japan, April 10, 1986

JAPANESE IMPORTS OF MANUFACTURED PRODUCTS (Percent of Total Imports)

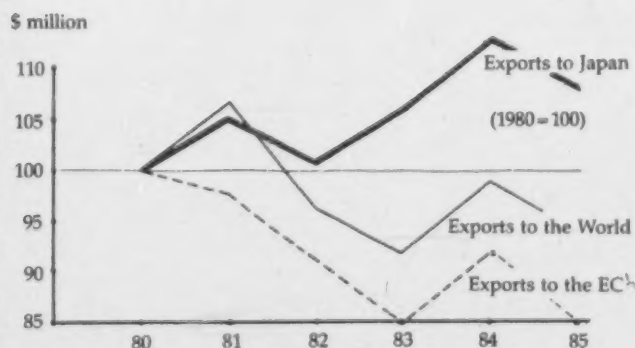


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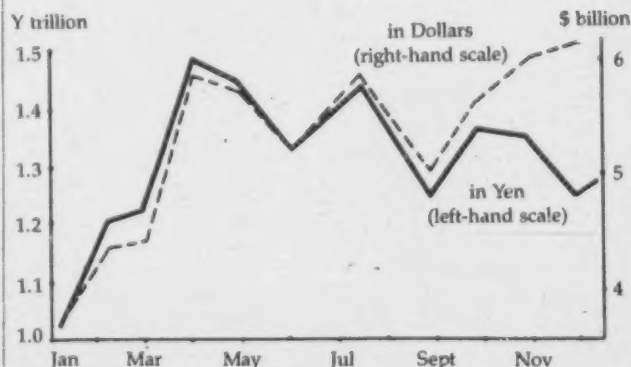
Source: Look Japan, April 10, 1986

U.S. EXPORT PERFORMANCE 1980-85



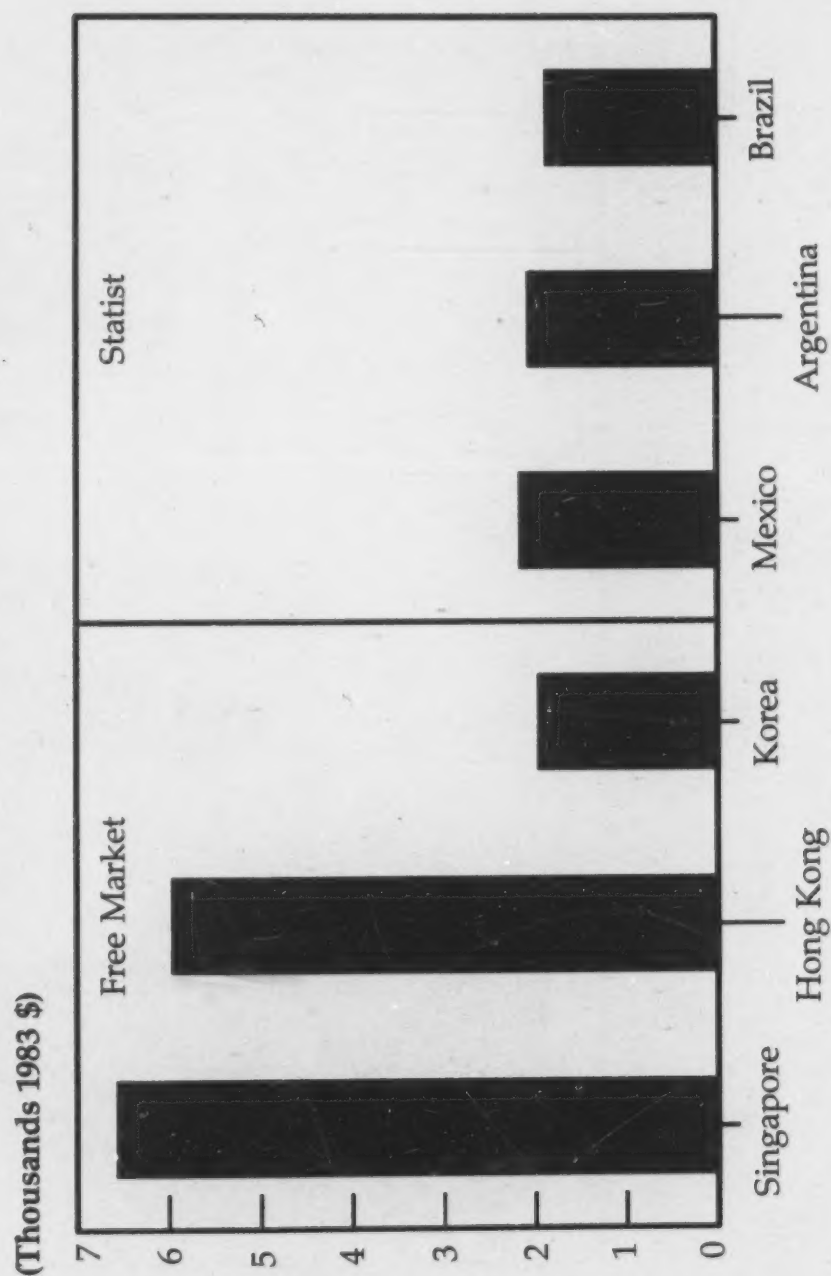
Source: Look Japan, April 10, 1986

JAPANESE EXPORTS TO THE U.S. 1985

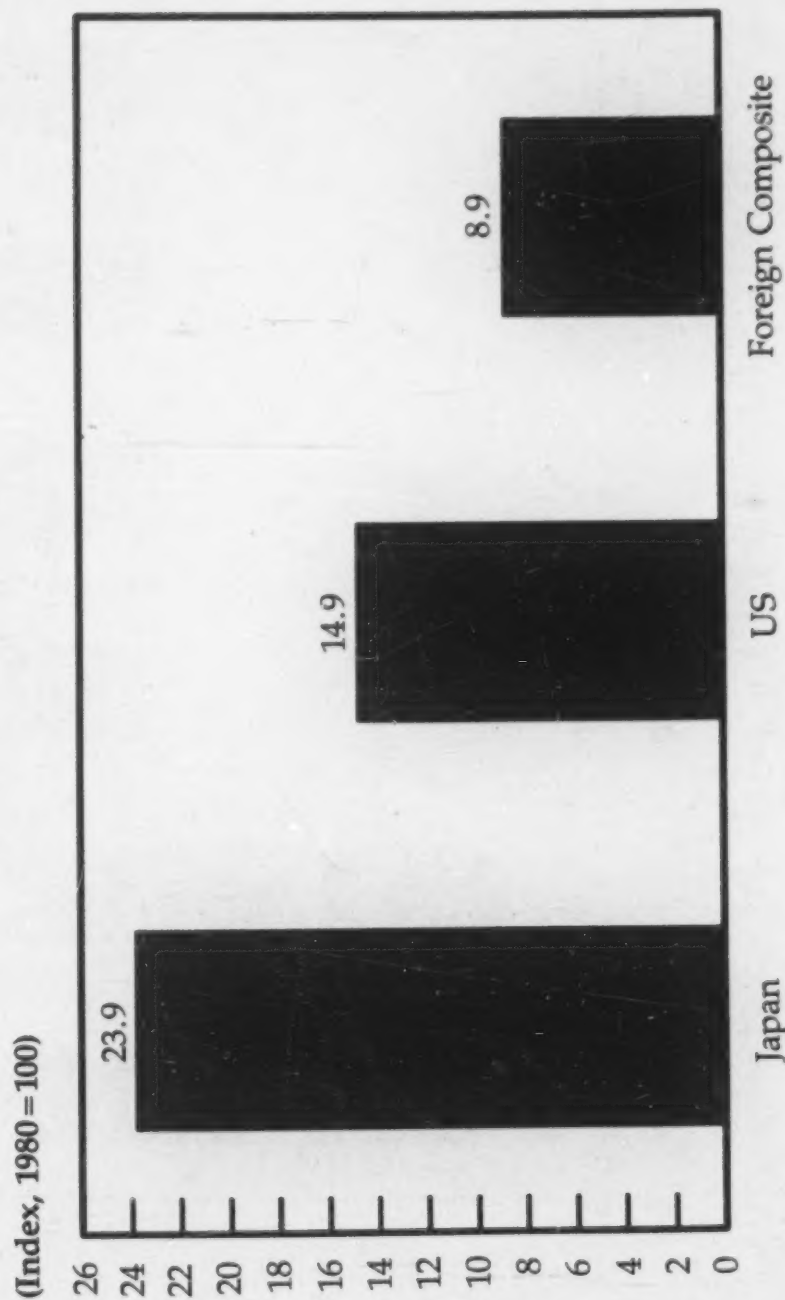


Source: Look Japan, April 10, 1986

Per Capita GNP in Free Market and Statist Economies



Increase in Industrial Production Since 1980



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

August/September 1986

TAX REFORM AND THE OUTLOOK

by
Richard W. Rahn and Graciela Testa-Ortiz

In spite of the fact that the recent revision to the National Income and Product Accounts shows that the domestic economy remains basically strong (real GNP rose by 3 percent during the first half of 1986 compared to the first half of 1985), great uncertainty regarding the outlook for the remainder of this year and next continues. The latest consensus forecast shows that real GNP is anticipated to rise by 2.2 percent and 2.7 percent during the third and fourth quarters of this year, respectively, compared to forecast increases of 3.2 percent and 3.1 percent, respectively, in January. According to the consensus, the outlook for 1987 seems to be even more uncertain. The predictions of the 52 forecasters surveyed by *Blue Chip Economic Indicators* range from an increase in real economic activity of 4.7 percent, to threats of imminent recession as reflected by predictions of a 0.7 percent decline in real GNP growth at the bottom of the *Blue Chip* range.

Beyond this year, the pessimism reflected in the average forecast for 1987 (the average forecast fell to 3 percent in August from 3.3 percent in July and 3.5 percent in June), appears to be directly linked to tax reform. In July, the *Blue Chip* forecasters were asked which factors would have the most unfavorable impact on 1987 economic growth. Eighty-four percent of the respondents stated that tax reform, particularly the reduction in business incentives, was the most unfavorable factor in the 1987 scenario.

The Impact of Tax Reform

Now that the House-Senate Conference Committee has reached a compromise, it is worthwhile to reiterate some of the findings regarding the impact of tax reform. In the December 1985 issue of *Economic Outlook*, we reported on the findings of a study, performed by the consulting firm of Laurence H. Meyer and Associates (LHM&A), on the impact of the House version of the bill. That study concluded that implementation of the House proposal would

result in a cumulative decline in real gross national product of \$145 billion between 1986 and 1991. In the June/July 1986 issue of this publication we noted that although the Senate version of the bill would have an initial negative effect on the economy, it was, nevertheless, a significant improvement over the House version and would have a positive influence in later years. In an effort to improve the final bill and diminish its initial negative impact, we suggested that four changes be made to ensure a smoother transition period. These four changes were as follows: 1) the tax rates should be reduced at the same time as the tax base is broadened; 2) the capital gains tax rate needs to be reduced; 3) the minimum tax needs to be reformed; and 4) the investment tax credit should not be repealed retroactively.

Of these four recommendations, only the timing of the rate cuts was altered by the House-Senate Conference Committee. The individual rate cuts will take place on March 15, 1987, while the corporate rate cuts will still take place on July 1 of next year.

In assessing the outlook for the next two and a half years, therefore, the likely impact of the outcome of the tax reform compromise needs to be addressed. According to the analysis prepared by LHM&A, the House version of the bill signifies declines in real GNP (from a base simulation that did not include tax reform), of 0.3 percent and 0.8 percent in 1987 and 1988, respectively. The Senate version, on the other hand, implies declines

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from the current law baseline of only 0.1 percent and 0.4 percent, respectively. If the Conference Committee report becomes law, the outcome is likely to be somewhere in between those two ranges. In sum, there will be transitional costs to the economy over the next two years which will reduce GNP slightly from the baseline projection. From 1989 onward, the new tax system ought to be a net plus to the economy. The Congress still has the opportunity to guarantee a long run positive outcome to the tax reform legislation if it modifies the obvious major negatives in the tax bill, namely, the treatment of capital gains and capital cost recovery.

The Expansion Measures Up Well To Past Experience

The pending tax reform bill is not the only factor affecting the wide range of forecasts for the remainder of this year and next. Thirty-four percent of the respondents to the *Blue Chip* survey regarding unfavorable factors in next year's outlook, stated that the business cycle was aging, that is, that since the expansion is already 46 months old it is doomed to die of old age. The reality, of course, is that growth periods die from policy mistakes, not old age. Given the continuing debate regarding the strength and longevity of the current phase of the cycle—a debate which began in 1983 with many forecasters anticipating an "anemic and short-lived" upturn—it seems an appropriate time to pause and re-examine the economy's performance thus far.

Despite earlier predictions, this recovery has turned into the third longest expansion in postwar history and the second longest peacetime expansion since 1945. Already into its 16th quarter, it is surpassed only by the 1975-1980 expansion which lasted 20 quarters, and the 1961-69 expansion which lasted 35 quarters. An examination of the data shows that while real GNP has increased at an average quarterly rate of 0.8 percent during the past ten years (1976:2 to 1986:2), the comparable figure for the past 15 quarters was 1.1 percent. And despite the second quarter's weakness, economic activity during the first half of the year was 2.9 percent above the comparable period in 1985. A comparison of this recovery with the 1960 and 1975 episodes shows that although it is lagging the previous experience, domestic demand remains remarkably strong, surpassing past performance in some sectors.

The apparent weakness, relative to the previous expansions, stems largely from the global trade imbalance which is reflected in the performance of U.S. imports and

exports. Indeed, real GNP minus net exports has performed slightly better than past experience. The swings in the real GNP growth rate during the past five quarters can be explained by swings in imports. In some cases, these swings were offset by opposite changes in inventories. Only in the most recent quarter do we see that inventory change and import growth both worked to the disadvantage of real GNP (see Forecast Table).

Domestic demand (GNP minus net exports) during the first half of 1986 was 4 percent above its year earlier level and 21 percent higher than the recession trough (compared to a 20.9 percent average increase during the past two recoveries which lasted this long).

TABLE 1
CYCLICAL EXPERIENCE*
(Percent)

Cycle Trough	GNP	Consumption	Investment
1960:4	20.0%	17.6%	25.6%
1975:1	20.4	18.6	67.1
Average	20.2	18.1	46.4
1982:3	16.1	17.5	92.1

Cycle Trough	Nonresidential Investment	Producers' Durable Equipment	Nonresidential Structures
1960:4	25.6%	37.2%	13.9%
1975:1	31.7	39.7	17.9
Average	28.7	38.5	15.9
1982:3	27.2	48.2	-5.9

Cycle Trough	Exports	Imports	GNP Minus Net Exports
1960:4	29.0%	26.7%	19.9%
1975:1	28.1	45.5	21.8
Average	28.6	36.1	20.9
1982:3	1.2	47.9	21.3

*Increase in real activity during the first 15 quarters of a cyclical upturn.

Despite repeated warnings regarding the sustainability of strong consumer spending, real consumption continues to support economic activity as has been the case since the beginning of the expansion. The latest data shows that real consumer spending rose at an annual rate of 6.5 percent during the second quarter, significantly above the 0.6 percent rise in total output. However, the performance of consumption is not out of line with previous experience. It has risen by 17.5 percent since the recession trough in the third quarter of 1982, compared to an average increase of 18.1 percent at this stage in previous expansions. Although consumer debt as a proportion of disposable income continues to scale new highs, continued improvements in employment (a record number of adults are now employed), and in household

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Ms. Rajni Bonnie Ohri, Economist.
Ms. Lyn Maness, Production Coordinator.

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1988
 Prepared by the U.S. Chamber of Commerce
 (Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS										YEARS			
	Actual			Forecast							Actual	Forecast		
	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4		1985	1986	1987	1988
GROSS NATIONAL PRODUCT														
Real GNP	2.1	3.8	0.6	3.5	3.6	2.8	3.4	2.9	2.6		2.7	2.8	3.0	4.0
Consumption	1.7	3.6	6.5	3.1	3.0	2.2	2.4	2.1	1.3		3.5	3.9	2.7	3.3
Residential Investment ...	3.4	11.0	13.5	2.3	2.2	-3.0	-4.4	-0.3	1.0		3.9	8.2	0.1	4.1
Nonresidential Investment	12.5	-15.1	-2.3	2.2	5.0	2.4	2.0	3.0	1.2		9.3	-0.6	2.5	4.4
Equipment	18.7	-19.0	19.9	1.1	4.8	1.9	1.0	2.4	0.0		10.1	4.1	3.1	4.0
Structures	0.3	-10.8	-38.6	4.7	5.4	3.4	4.7	4.6	4.0		7.7	-10.3	0.9	5.4
Exports	8.2	7.1	-5.6	16.8	9.1	9.9	10.8	11.3	11.5		-2.0	3.5	10.1	10.3
Real Net Exports (82\$B) ..	-132	-125.9	-150.5	-144.6	-139.5	-131.8	-122.2	-111.7	-99.5		-108.2	-140.2	-116.3	-89.7
Imports	23.3	0.2	16.5	7.3	2.5	1.2	0.6	0.5	-0.5		3.8	9.5	2.8	3.0
Government Purchases ...	22.7	-27.5	11.9	7.2	22.2	-19.1	-0.9	5.2	15.6		10.9	3.5	1.1	-0.2
Final Sales	2.7	-1.3	3.8	3.7	5.3	0.7	2.8	3.6	3.8		4.2	2.5	3.0	3.8
Change in Business														
Inventories (82\$B)	-5.2	39.9	11.6	14.8	-0.2	18.9	24.6	18.1	7.6		9.0	16.5	17.3	28.6
Industrial Production	2.0	2.0	-0.9	1.8	5.7	3.7	5.3	4.2	3.8		2.6	1.7	3.9	6.2
Total New Car Sales (mill.)	10.3	11.0	11.0	10.9	10.6	10.8	11.0	11.0	10.8		11.2	10.9	10.9	11.1
Domestic Car Sales (mill.)	7.0	7.8	8.1	8.0	7.7	7.9	8.1	8.1	7.9		8.2	7.9	8.0	8.2
New Housing Starts (mill.)	1.77	2.00	1.91	1.88	1.89	1.75	1.76	1.76	1.77		1.74	1.92	1.75	1.93
EMPLOYMENT, WAGES AND PRICES														
Civilian Unemployment														
Rate (%)	7.0	7.1	7.2	7.0	6.9	6.9	6.8	6.7	6.9		7.2	7.1	6.8	6.3
Compensation	3.7	3.1	2.3	2.5	2.6	3.6	2.8	2.9	3.1		4.0	3.0	2.9	3.6
Productivity	-3.5	4.3	1.9	1.0	2.3	0.8	1.3	0.8	0.7		0.5	1.4	1.2	1.4
Unit Labor Costs	7.4	-1.2	0.3	1.5	0.3	2.8	1.4	2.0	2.3		3.7	2.7	2.2	2.5
Consumer Price Index	4.3	1.4	-1.7	2.1	2.4	2.3	2.6	2.6	3.3		3.5	1.8	2.2	3.4
Implicit GNP Deflator	3.6	2.5	2.5	2.2	2.2	2.2	2.2	2.4	2.6		3.3	2.6	2.2	3.1
Prime Interest Rate (%) ...	9.5	9.4	8.6	8.1	7.6	7.5	6.8	6.4	6.2		9.9	8.4	6.7	6.1
3-mos. Treasury Bill														
Rate (%)	7.2	7.0	6.1	5.6	5.1	5.0	4.5	4.5	4.4		7.5	6.0	4.6	4.5
Corporate Bond Rate (%) ..	10.6	9.6	9.0	8.8	8.4	8.3	7.9	7.7	7.6		11.4	9.0	7.9	7.1
Real Personal Disposable														
Income	2.8	6.4	7.3	-1.1	1.4	3.4	1.6	1.6	0.9		1.4	3.4	2.0	3.0
Profits from Current														
Production (\$B) ¹	189.2	207.3	200.1	194.0	209.5	171.4	174.1	200.8	201.7		188.9	202.2	187.0	217.1
GOVERNMENT FISCAL POLICY (\$B)²														
Unified Receipts											736	766	836	908
Unified Outlays											937	989	1015	1070
Unified Deficit											-201	-223	-179	-162

¹After-tax corporate profits with inventory valuation and capital consumption allowances.

²Unified budget figures on a fiscal year basis.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's outlook contains the July revisions to the National Income Accounts for the second quarter of 1986. The forecast incorporates provisions of the tax reform plan. These include: reductions in personal and corporate marginal income tax rates, repeal of the ITC, less generous depreciation allowances for structures, and elimination of the preferential treatment of capital gains income. These changes are implemented consistent with the static revenue estimates reported by the Joint Committee on Taxation. The nation's money supply (M1) is assumed to grow by 11.7 percent in 1986, 7.3 percent in 1987, and 6.7 percent in 1988. The trade weighted exchange value of the dollar falls by 15.2 percent in 1986, 4.5 percent in 1987, and stabilizes in 1988. The price of imported oil averages \$14.00 per barrel. The federal minimum wage is not expected to increase.

assets, and low interest rates, have raised consumer buying attitudes to their highest level in 40 years.

Spurred by low interest rates and increased incomes, which translates into improved housing affordability, residential investment continues to rise impressively. Since the end of the recession, residential investment has increased by 92 percent, surpassing previous episodes by a wide margin.

Nonresidential fixed investment continues to perform well despite the uncertainty created by the tax reform debate. The stellar performer in the nonresidential investment sector is investment in producers' durable equipment. Despite weakness in some sectors, overall growth in this category of investment has surged by 48 percent compared to an average improvement of only 38.5 percent during past recoveries. The strength of equipment investment has offset weakness in nonresidential structures, contributing to an overall improvement in nonresidential fixed investment of 27 percent compared to a recovery increase of 25.6 percent during the comparable period of the 1960 expansion and 31.7 percent in 1975.

Other measures of economic health also remain positive. Inflation, as measured by the implicit deflator for real GNP, has risen by 12.9 percent compared to an average recovery increase of 17.7 percent and the improvement in nonfarm output per manhour, at 7.1 percent, compares favorably with the 1975 period. The performance of the manufacturing sector has been even more impressive and unit labor costs have actually declined during this recovery.

Moreover, while the 0.6 percent increase in real GNP posted during the second quarter seems, to some analysts, to foreshadow further weakness in U.S. economic activity, a closer examination of the data shows that this is far from the case. As noted previously, second quarter growth was eroded by a 16.5 percent increase in imports and a \$28.3 billion decline in inflation-adjusted inventory accumulation. The turnaround in inventory accumulation represents a correction from the surge in unplanned stockbuilding during the first quarter, which resulted from a 1.3 percent decline in real final sales. This correction, we believe, will have run its course by the end of the year and thereafter contribute to enhance real growth. The surge in real imports is accounted for by a significant rise in petroleum imports to more than 7.8 million barrels a day in June, the highest rate since February 1980. The jump in oil imports was in reaction to declines in oil prices which prompted a rebuilding of U.S. oil inventories.

The Current Outlook

According to the Department of Commerce's Bureau of Economic Analysis, the composite index of leading in-

dicators has risen by 2.8 percent during the first half of 1986 and by 6.5 percent over its June 1985 level. Interest rates are now at their lowest level since 1977. Consumer prices have increased by only 1.8 percent during the past twelve months. Nonfarm labor productivity rose at an annual rate of 4.3 percent in the first quarter and 2 percent in the second, following a 0.5 percent increase during 1985. Real personal disposable income increased by 6.4 percent during the first quarter and 7.3 percent during the second quarter. Nonagricultural employment rose by 389,000 in July.

The data presented not only shows that the U.S. economy is performing well, but that prospects for the remainder of the year remain strong. In addition to tax reform, the outlook will be shaped by the impact of low oil prices, the decline in the value of the dollar and low interest rates. The bulk of the initial negative impact on the domestic oil and related industries of the falloff in oil prices has already been felt. During the rest of the year, the economy will get a boost from lower oil prices. Low interest rates will continue to support a strong residential sector. New housing starts, which averaged a strong 1.95 million units during the first half of the year will remain in the 1.9 million unit range. Nonresidential investment is expected to post a 0.7 percent decline brought about by a 10 percent fall in structures. However, investment in producers' durable equipment is expected to continue growing, albeit at a slower pace. Consumer spending is anticipated to grow substantially faster than the overall economy in 1986 and will continue to support economic activity in 1987 and 1988.

While the decline in the dollar has yet to be reflected in the trade data, continued slides in the U.S. currency and stronger overseas demand are expected to foster a turnaround in real net exports during the second half. It must be noted, however, that U.S. demand has single-handedly kept the world economy afloat. If domestic demand in our major trading partners, particularly West Germany and Japan, remains weak, the decline in the value of the dollar, by itself, cannot be expected to foster growth in U.S. exports (see the article that follows).

THE TRADE CONUNDRUM

by
Graciela Testa-Ortiz

The trade-weighted value of the dollar has fallen by 30 percent since its peak in February 1985. This decline, by making U.S. goods and services comparatively less expensive abroad, was expected to increase foreign demand

for U.S. products. Similarly, by making foreign products more expensive at home, it should have reduced domestic demand for imports. As a result, the trade gap was expected to narrow. But this has not happened; U.S. exports have barely risen and imports continue to rise.

There are several reasons why export growth has not yet improved significantly. Two of the major ones are discussed in this paper. First, there is a lag between changes in currency values and their impact on the trade balance. Second, the economies of our major trading partners are in a slump because high real interest rates are suppressing economic activity abroad. As will be shown, stimulative policies in Western Europe and Japan would go a long way toward solving the current trade imbalance.

The J-curve

Part of the explanation for the continuation of the trade imbalance lies in the so-called "J-curve effect." This refers to the fact that export and import volumes do not adjust immediately to changes in prices. The initial impact of exchange rate depreciation is a worsening of the trade deficit as the value of imports rises and the value of exports falls (for a given volume of exports and imports). The existence of dollar-priced contracts for some products, for instance, means that prices do not change until the contracts expire. The dollar's depreciation opens up new markets for U.S. goods, both for U.S. companies that were already exporters and for those who had not previously explored the possibility. However, it takes time for these firms to acquire the capacity and expertise necessary to increase production and meet the increased foreign demand.

Research has shown that the adjustment of export and import volumes to changes in currency values may take many months to complete, but the bulk of it should be completed in about two years. Therefore, the continued deterioration in the U.S. trade balance could be attributed to the impact of past dollar accelerations. That is, the dollar depreciation has not been in effect long enough for it to have an impact on the nation's trade balance. But this does not adequately explain current developments. The dollar decline began 18 months ago; therefore, most of the J-curve related adjustments should be, in large part, completed. Moreover, the dollar's decline since the time of the Plaza Agreement last September is a matter of U.S. policy (sometimes more explicitly stated than others), so that any questions regarding the sustainability of the initial slide should have been laid to rest by now.

The Dollar and the Trade Data

The trade-weighted measure of the dollar masks significant differences in its value *vis-a-vis* particular trading partners. For instance, since March 1985, the dollar has depreciated by 37.4 percent against the mark, but only 0.7 percent against the Canadian dollar. At the same time, it has not declined in value with respect to many curren-

cies which are pegged to the dollar. We might, therefore, expect to see a narrowing of the trade gap with those countries whose currencies have appreciated against the dollar and no improvement in the trade balance with those whose currencies have not changed. However, this does not appear to be the case. Despite the dollar's depreciation, imports by country have generally risen significantly faster than exports since the dollar's slide began.

TABLE 1
THE DOLLAR And U.S. TRADE
(Percent)

	Dollar Decline ¹	Exports ²	Imports ²
Canada	-0.7%	-3.4%	+1.6%
France	-33.6	+15.9	+10.6
West Germany	-37.4	+5.0	+23.2
Italy	-31.5	-3.7	+19.9
United Kingdom	-26.4	-13.7	+17.7
Japan	-40.2	-7.2	+21.9
Total	-30.0 ³	-3.5	+11.8

(1) Percent change from March 1985 to August 9, 1986.

(2) Percent change from first quarter of 1985 to the first quarter of 1986.

(3) Trade-weighted index.

Source: *The Economist*, various issues.

Department of Commerce, Bureau of Economic Analysis.
Forecasting Section, U.S. Chamber of Commerce.

Nevertheless, we may have already turned the bend in the J-curve. The trade data shows that real exports of goods and services have risen by 2.3 percent since the third quarter of 1985. By region, nominal merchandise exports to Western Europe have risen by 21.8 percent since mid-1985. Merchandise exports to Japan have also improved, rising by almost 3 percent between 1985:3 and 1986:1. Even exports to Asia and Canada, whose currencies have hardly budged against the dollar, have improved.

The problem is that imports have increased at a faster pace. But this rapid growth in imports may now be tailing off. A comparison of the last three quarters (1986:2 compared to 1985:4) shows that nominal merchandise imports fell by 1.5 percent; in real terms (after accounting for inflation), they rose by only 6.1 percent. As a result, a small turnaround in net merchandise exports is now evident, but the emphasis is on the word *small*. Our bilateral merchandise trade gap with those countries whose currencies have appreciated against the dollar remains virtually unchanged.

Who's Buying...?

A reason for the continued imbalance in trade is economic stagnation abroad. During the first quarter of this year, real GNP fell in most of the major industrial countries. While the declines in economic activity in France and Italy were small, they were quite substantial

in West Germany (-6.5 percent) and Japan (-2 percent). This weakness in the economies of our trading partners explains their inability to increase imports. It also explains their eagerness to export as their businesses look abroad for healthier markets. In effect, the United States continues to be the only engine of growth in the world economy.

Why are the industrial economies stagnating? One of the reasons is evident in a comparison of interest rates in West Germany, Japan and the United States. The interest rate on long-term government bonds stands at 6.1 percent in West Germany, 5 percent in Japan and 7.4 percent in the United States. Although, in nominal terms, interest rates are much higher in the United States, this is not the case in real terms. (The "real" interest rate is the nominal rate of interest minus the rate of growth of inflation.)

During the past twelve months wholesale prices declined by 2.8 percent in West Germany, 10.1 percent in Japan and 1.6 percent in the U.S. This means that the real interest rate on long-term government bonds stands at 8.9 percent in West Germany, 15.1 percent in Japan and 9 percent in the U.S. From this calculation, one can only conclude that real interest rates in Japan are significantly higher than those in West Germany and the U.S. However, the current level of interest rates is not the only relevant factor. The path that real rates have followed during the past year is particularly important. Comparing current real rates to what they were during the second quarter of 1985 shows that while they fell by 1.5 percentage points in the U.S., they rose by 4.7 percentage points in West Germany and 9.2 percentage points in Japan. Given the pattern of interest rates in West Germany and Japan, it is no wonder that their economies are in a slump.

TABLE 2
REAL INTEREST RATES¹
(Percent)

	1985:2	August 9, 1986	Change ²
United States	10.5%	9.0%	-1.5%
Japan	5.9	15.1	+9.1
West Germany	4.2	8.9	+4.7
France	2.5	7.6	+5.1
Italy	5.7	15.4	+9.7
United Kingdom	5.4	5.1	-0.3

¹Nominal interest rate on long-term government bonds minus the twelve-month change in wholesale prices.

²Percentage point difference.

Source: *The Economist*, various issues.

Forecasting Section, U.S. Chamber of Commerce.

Both Japan and West Germany have failed to realize that they can offer much lower interest rates. The reason for not doing so is the fear that a more expansionary stance of monetary policy will fuel inflation. While this fear is well-founded, the fact that both countries are facing deflation, not inflation, seems not to be fully recognized. As of June 1986, according to IMF data, world commodity prices have fallen by 19.8 percent from their 1981

level. In addition, both countries seem to be ignoring the fact that the appreciation of their currencies will further reduce domestic inflation.

In defense of their reluctance to lower domestic interest rates, the West German authorities quibble over the correct price index to use in adjusting nominal interest rates. Instead of using consumer or wholesale prices (which include the price of imports), they hold that the implicit deflator for GNP (which does not), provides a better measure of "underlying" inflation. Thus, using the GNP deflator, they arrive at a real interest rate of about 2 percent. This argument misses the point, however. Firstly, the choice of an index of inflation which excludes falling prices is questionable. The decline in commodity prices is not a statistical quirk but an established trend. Secondly, if, in fact, the GNP deflator were the correct price index to use, then one would expect the dollar to be appreciating, not depreciating, with respect to these currencies. That is, the differential between real interest rates in the U.S. and West Germany and Japan should be increasing the attractiveness of dollar-denominated assets relative to mark- and yen-denominated assets and thus increasing the demand for dollars relative to marks and yen. This is clearly not the case.

West German officials contend that their country's economy is too small to solve the problems of the world. True, West Germany's share of total industrial country GNP is about 9 percent—a small number—but it still makes West Germany the third largest industrial economy. Both the West Germans and the Japanese also assert that the U.S. has not done its part. A large part of the blame, they claim, lies with the large U.S. budget deficit which led to high interest rates and, in turn, resulted in exchange-rate distortions. This argument has been countered many times. There is no conclusive evidence to show that large budget deficits lead to high interest rates. In fact, recent experience proves the opposite: interest rates have fallen dramatically while the deficit has reached ever higher levels.

U.S. criticism now may seem quite unfair to the West Germans and Japanese. After all, aren't their interest rates high because they cooperated with the United States' efforts at lowering the value of the dollar last September? Even admitting this fact, the point remains that almost a full year after the initial intervention, the European and Japanese economies are stagnating and prospects for the remainder of this year are doubtful. What was necessary to halt the rise in the value of the dollar was an increase in the rate of return of mark- and yen-denominated assets relative to that of dollar-denominated assets. The Japanese and the Germans chose to do this through increases in real interest rates. But the same result could have been obtained through fiscal policy; namely, a tax cut which would have improved their after-tax rate of return and growth potential, particularly in the case of West Germany.

Both the Japanese and the West Germans have so far been impervious to U.S. criticism. As a result, the Federal Reserve has just implemented its second discount rate cut without any advance agreement with Japan and West Germany. However, the impact of the continued appreciation of their currencies *vis-à-vis* the dollar on their export sectors (which are much more important as a proportion of total GNP than they are in the United States), may force them to act. When the West German and Japanese economies begin moving again, growth in the rest of the industrialized world can resume. Since Western Europe and Japan together accounted for 36.5 percent of U.S. exports of merchandise in 1985, we can then expect to see further improvements in our trade accounts.

Conclusion

The policy changes advocated in this paper; namely, stimulative fiscal and monetary policies in the developed countries, with particular emphasis on the reduction of high real interest rates in Western Europe and Japan, would go far toward increasing global economic activity and trade. These policies need not be inflationary since monetary policy is not the only policy instrument available. There is still a great deal that needs to be accomplished in the areas of tax reform and the reduction of government intrusion in the production process.

Increased economic activity in the industrial nations will firm world commodity prices. But, because technological changes have increased the supply of and reduced the demand for primary commodities in the industrial process, this increase in commodity prices will in no way resemble the inflationary spiral of the 1970s. In addition, the enormous amount of unused resources worldwide (most painfully reflected in high unemployment rates in Western Europe), will also suppress inflationary pressures.

Finally, stronger industrial country growth will have the added advantage of increasing the markets for developing country exports, thus improving their ability to finance their debt.

CHANGING PERSPECTIVE ON BANK FAILURES

by
Rajni Bonnie Ohri

Despite the drumbeat of headlines about loan defaults, large write-offs and failing banks and thrifts, the outlook for the U.S. financial system is brighter than many people think. Although 1985 was generally a prosperous year

for the banking industry, not since 1933 have so many insured banks failed in a single year. Putting the problems in perspective, it should be noted that the 120 banks that failed in 1985 accounted for only 0.8 percent of all insured commercial banks. Somewhat more troubling, however, is the fact that 1,260 institutions, representing 8.5 percent of the 14,405 banks insured by the Federal Deposit Insurance Corporation (FDIC), are on its list of "problem banks." In large part, the problems faced by the U.S. banking industry are linked to regional economic factors and are centered among the smaller banks located in areas of the country where conditions in the agriculture and energy industries have deteriorated since 1981.

Bank Failures During 1985

The 1980s have been difficult years for some commercial banks and, in particular, for small banks with a focus on agriculture and energy loans. Many of the changes that are underway in the banking industry stem from changes in the underlying economy associated with volatility in the prices of key commodities. Hardest hit by this price volatility are the very companies that benefited the most from high inflation in the 1970s. The assets that once promised to increase in value indefinitely—tangibles such as petroleum, office buildings, farmland and metals—have lost luster as their prices have declined. The most troubled industries—electric utilities, energy, real estate, agriculture, mining and shipping—are all plagued by overcapacity and declining prices, born of the 1970s environment.

In particular, the farm crisis is continuing to devastate banks which are highly exposed to farmers and farm-related businesses. A substantial number of farms are facing business failure due to years of declining farm prices and land values and thus, are unable to repay their bank loans. In addition, the recent precipitous drop in oil prices has dealt a painful blow to banks which have outstanding energy loans, further straining bank loan portfolios.

About 70 percent of the nation's agricultural banks and a large share of all energy banks are located in the West North Central region (the Dakotas, Minnesota, Nebraska, Iowa, Kansas and Missouri) and the West South Central region (Oklahoma, Arkansas, Texas and Louisiana). At the same time, these regions contain nearly half of the nation's 11,800 small banks. As a result, problems in the agriculture and energy sectors have had a disproportionate impact on small banks, accounting for a substantial amount of their profitability problems.

In 1985, twenty-one states experienced bank failures. As shown by Table 1, the highest number of failures occurred in Kansas, Nebraska and Oklahoma. Texas, Iowa and Missouri followed close behind. In most of these states, farm banks continue to fail at a disproportionately high rate. A recent report issued by the FDIC concluded: "Agricultural bank failures took a sudden upturn during

TABLE 1
NUMBER OF BANK FAILURES BY STATE
1982-85

	1985	1984	1983	1982
Alabama	2	1	1	1
Alaska	-	-	-	-
Arizona	-	-	-	-
Arkansas	1	2	1	3
California	7	6	5	2
Colorado	6	2	1	-
Connecticut	-	-	-	-
Delaware	-	-	-	-
Dist. of Columbia	-	-	-	-
Florida	2	2	-	1
Georgia	-	-	-	-
Hawaii	-	-	-	-
Idaho	-	-	-	-
Illinois	2	5	6	5
Indiana	1	2	-	-
Iowa	11	3	-	2
Kansas	13	7	1	-
Kentucky	-	1	1	-
Louisiana	-	1	-	-
Maine	-	-	-	-
Maryland	-	-	-	-
Massachusetts	-	-	-	1
Michigan	-	1	-	1
Minnesota	6	4	1	1
Mississippi	-	1	-	-
Missouri	9	2	1	2
Montana	-	-	1	-
Nebraska	13	-	1	-
Nevada	-	-	1	-
New Hampshire	-	-	-	-
New Jersey	-	1	1	1
New Mexico	3	-	-	-
New York	4	-	2	4
North Carolina	-	-	-	-
North Dakota	-	-	-	-
Ohio	-	-	-	-
Oklahoma	13	5	1	3
Oregon	3	5	5	-
Pennsylvania	-	-	-	1
Puerto Rico	-	1	1	1
Rhode Island	-	-	-	-
South Carolina	-	-	-	-
South Dakota	-	1	1	-
Tennessee	5	11	12	3
Texas	12	6	3	7
Utah	1	1	-	-
Vermont	-	-	-	-
Virginia	-	-	-	1
Washington	-	-	-	1
West Virginia	-	-	-	1
Wisconsin	1	-	-	-
Wyoming	5	2	1	-
Total	120	79	48	42

Source: The American Banker, FDIC.

the second half of 1984. During the past 14 months farm banks accounted for just over 50 percent of all bank failures. Nonagricultural banks have been failing at about the same pace in 1985 as 1984, meaning that the increased number of agricultural bank failures account for nearly all of this year's higher failure rate."

Troubled Sectors

Many farm banks are finding it difficult to withstand the pressures created by adverse developments in the agricultural sector during the past several years. There are close to 4,000 banks that have 25 percent or more of their loan portfolios in farm and farm-related business loans. This represents about 28 percent of all commercial banks. Commercial banks, in general, hold \$49 billion, or 24 percent, of the total farm debt outstanding. At the end of 1985, nearly 40 percent of the FDIC's *problem* commercial banks were farm banks, up from 24 percent two years earlier. Most of these banks are small, with total assets equal to only about 4 percent of all U.S. commercial bank assets.

In 1982 and 1983, there were a total of 14 agricultural bank failures. This figure almost doubled in 1984 to 25 bank failures. Last year, an additional 62 agricultural banks failed and so far this year 13 have been closed. The rapid growth in these failures has occurred primarily because of the plunge in the value of rural land, the ultimate collateral for most of the loans. Between 1981 and 1986, some farm land values declined by 60 percent or more. At the same time, most agricultural lenders have delayed foreclosures rather than throw farmers off the land, and this has contributed to further bank losses as the loans have continued to deteriorate in quality.

Although the above description paints a dreary picture of the farm economy and the agricultural finance system, there are signs that the situation will stabilize by next year (see "American Agriculture at the Crossroads," *Economic Outlook*, October, 1985). The drop in the value of the dollar and interest rates are encouraging signs. With a lower-valued dollar, U.S. agriculture exports should improve somewhat. On the positive side, farm banks have traditionally been well capitalized, offering some protection, in the short run, from loan losses. The aggregate primary capital ratio for these banks is about 10 percent, well above that of other small banks. Moreover, the FDIC reports that only about one percent of these banks have a primary capital ratio below six percent.

Mirroring the hard times of the agriculture banks, the Southwest region's banks are experiencing problem energy loans. Texas, Oklahoma and Louisiana have experienced the highest rate of energy bank failures. Many industries in these states are in the throes of a fundamental structural adjustment process as businesses that prospered with the oil boom continue to adjust to the low demand for petroleum and petroleum-related products.

There are 563 state-chartered banks that have over 25 percent of their capital invested in loans to domestic oil and gas companies, totalling \$61 billion. Of these, 103 are on the FDIC's list of problem banks. In addition to the troubled state banks, there are 245 nationally-chartered banks in the same situation, with nearly \$40 billion in

outstanding oil and gas loans. First City Bankcorporation of Houston, with 64 banks in its network, absorbed over \$260 million in bad loans last year alone, many of them to oil drilling firms. Tulsa-based BancOklahoma reports that more than 1/20th of its loans are delinquent, twice the industry average.

Under pressure from regulators and investors, many Texas and Oklahoma banks have begun following belt-tightening measures by taking substantial charges against earnings to bolster reserves for possible loan losses. Faced with write-offs exceeding \$2.5 billion, or nearly 3 percent of their total loans, Texas' six major banks have sacrificed earnings, sold assets, and slashed payrolls by as much as 10 percent.

No Cause for Alarm

Admittedly, bank failures present painful problems, but they are not overwhelming. The banking system has, in fact, absorbed the 120 failures in 1985 with relative ease, showing impressive resiliency. That is because the banks themselves, with few exceptions, have been small—only 12 have had deposits of over \$40 million. Moreover, the failed banks represent less than one percent of all commercial banks in the country and the total of their assets—\$8 billion—accounts for three-tenths of one percent of the \$2.7 trillion of the nation's banking assets. In addition, the fact that the failures have been concentrated in only a few industries has helped regulators contain the problem.

In nearly 80 percent of the failures, banking operations continued with little interruption. No insured depositors have lost money, and, in almost every case, the banks have been closed on Fridays and opened the following Monday. Perhaps the most important barometer of how the economy is absorbing these failures is the reaction of depositors, who seem unconcerned as long as their accounts are insured by the FDIC for up to \$100,000.

In 87 cases, the FDIC arranged for a healthy bank to purchase some of the assets and assume the deposit liabilities of a failed bank. For instance, because of excessive lending to farmers and farm-related businesses, the Auburn Savings Bank of Auburn, Iowa, with \$6.8 million in deposits, became insolvent as depressed commodity and land prices made it impossible for farmers to repay their debts. Acting along with the state banking commissioner, the FDIC shut it down, found a healthy acquiring bank—the Carroll County State Bank of Carroll, Iowa—and reopened Auburn in a few days as a branch of Carroll County. No depositors lost money and business continued as usual, but under a different name. The death of a bank was quiet, swift and almost painless.

Some observers, however, have voiced concern regarding these widespread guarantees by the federal government, noting that it tends to encourage high risk taking

by the banks since failure is at the government's expense, not the banks'. As a result, regulators are pushing, and Congress is considering, a plan that would assess banks an extra insurance premium if they are engaged in risky lending practices. Moreover, legislators are attempting to extend the laws governing interstate takeovers to permit healthy banks to buy sick ones before they fail.

Conclusion

Despite all the turbulence, banks are thriving, particularly in those regions whose economies are not tied to troubled sectors. For example, in spite of the serious drought that has crippled farming in the Southeast, banks there have been booming as most states in the region have passed interstate banking laws, allowing banks wider latitude in diversifying their loan portfolios.

When considering the trouble spots of the economy, it is important to keep in mind that the basic problem faced is one of the difficult conditions of the agricultural and energy economies and not a banking problem as such. Bank regulators may provide some short-term and limited aid, but only a return to prosperity by the agriculture and energy sectors can bring a cure.

COMPARABLE WORTH: IS THE VALUE OF A JOB DETERMINED BY WHO DOES IT?

by
Martin Lefkowitz*

Men earn more than women. The evidence is incontrovertible. In 1985, the average pay for women who worked full time was \$277 per week—about 68 percent of what the average man earned in the same year. Women managers and professional and administrative workers did a tad worse during the year; their pay was less than 65 percent of that in comparable positions. This pay differential has been at approximately the same level for decades. The Equal Pay Act of 1963 and Title VII of the Civil Rights Act of 1964, both of which outlawed sex-based discrimination in jobs and pay, appear to have had virtually no effect on the differential.

But a pay differential does not prove discrimination, in spite of the fact that some court decisions appear to say that it does. For example, the courts have compared the wages of painters to those of typing pool supervisors and have ruled that by paying painters, who are primarily men, more than typing pool supervisors, who are primarily women, a government agency was discriminating

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against women. Unfortunately, the court did not have the common sense to say that if a teacher wanted to earn as much as a painter, she need only apply for that job. If she were not hired for a predominantly male position because of her sex; or if she were hired, say, as a painter, but paid a lower wage than her male colleagues, then she would have a legitimate sex discrimination complaint.

What Is Comparable Worth?

Comparable worth, the concept of comparing dissimilar jobs requiring similar levels of training and responsibility, was given its greatest boost from a case involving the state of Washington. Under Governor Dan Evans, the state hired a consulting firm to determine whether male and female employees holding jobs of comparable skill levels and responsibility were receiving the same pay. The study revealed that, based on the principle of comparable worth, women, on average, were being paid 20 percent less than men. A comparison of the wages of laundry workers and truck drivers, whose jobs were estimated to be of "comparable worth," showed that the laundry workers, who were primarily women, were paid about 41 percent less than the truck drivers, who were primarily men.

As a result of this study, the focus of the debate has switched. Originally, the question was the following: Do female lawyers or supermarket clerks make more or less than men in the same jobs? Now the question being examined is one of job segregation—do women gravitate toward jobs that are traditionally "women's" jobs or is it a pattern of job discrimination that pushes them into these lower paying jobs? Further, if they do choose these jobs, is it the obligation of society to develop a pay system that will reward them equally even if the labor market dictates a lower value for these occupations?

Sex Discrimination and Market Pressures

The push behind comparable worth is based on the notion that twenty years after the passage of Title VII of the Civil Rights Act of 1964, which outlawed sex discrimination in employment, it continues in more subtle forms. The comparable worth principle is based on the belief that certain jobs, which are filled predominantly by women, have lower pay scales because of a cultural bias which depicts the work of women as having less intrinsic value than the work of men. In essence, the contention is that women, as a class, face discrimination. The fact that an employer pays wages that are on a par with those paid by other employers in the community in no way enters into consideration.

There are two factors that personnel managers consider when developing a pay system; namely, internal equity and external competitiveness. However, this is not the same system used to analyze comparable worth. The point system, which is used as the basis for analyzing comparable worth, compares those aspects of all jobs that

are similar rather than comparing the jobs themselves. As such, it ignores the issue of external competitiveness. Under the point evaluation system, the emphasis is on where the job may fit in the organization and the skills and training needed for that job, rather than the level of market demand for certain job skills. For instance, although there may be a glut of airline pilots, this system would dictate that employers continue to pay pilots perhaps as much as \$100,000 a year rather than the \$30,000 a year that the market might dictate. The point evaluation system effectively short-circuits the role of supply and demand in the labor market—the traditional wage-setting mechanism of a free-market economy. In doing so, it seriously distorts the most valuable quality of a free market: the determination of prices (and wages) that efficiently allocates society's scarce resources to their most valuable uses.

The factors which are generally used to evaluate job comparability are knowledge, skills, mental demands, accountability, and working conditions. Such a system would conclude, therefore, that the job of a lawyer is always worth more than the job of a legal secretary, even though in the marketplace, a good legal secretary may often earn more than a mediocre lawyer.

Even proponents of the point evaluation system are critical of such a system as it is currently used. The criticism stems from the subjective nature of the evaluation process. It is argued that the system of point evaluation tends to place a greater weight on those factors that overstate the value of predominantly male jobs as opposed to predominantly female jobs. The critics assert that the elimination of wage differentials for women working in occupations that are dominated by men would not do much for the fact that women, on average, earn significantly less than men. The problem, as they see it, is that women who work in predominantly female occupations such as nurses, secretaries, grade school teachers, typing pool supervisors, and clerks are making less money than men in "comparable" occupations, mainly because of cultural bias.

The New York Times recently reported on specific examples of wage disparities between male and female occupations with similar point rating systems. The report was based on various studies of the concept of comparable worth. For instance, the report found that in Illinois, licensed practical nurses, a female-dominated occupation, are paid about \$1,298 per month, less than one-half the monthly pay for electricians, even though both jobs were deemed similar in terms of the comparable worth principle. Table 1 shows other jobs with similar point evaluations but significantly lower pay scales based on the predominant gender of those usually occupying such positions.

The job matches on Table 1 are but a few of the jobs determined to be comparable in worth based upon

studies in the states of Washington, Illinois, and Minnesota. The irony of these comparisons is that, while they appear to be scientific in nature, they are based on a very high degree of judgment. If the person performing the job evaluation overstates the value of certain skills, the result can be lopsided. The best example of this is the contention of women's groups that too much emphasis is placed on physical strength in certain job evaluations. However, even the perfect system for developing internal job equity would still not deal with the second essential element in a pay system; namely, external competitiveness.

TABLE 1
COMPARABLE OCCUPATIONS AND WAGE
DISPARITIES BY GENDER

<u>Female</u>		<u>Male</u>	
<u>Occupation</u>	<u>Monthly Salary</u>	<u>Occupation</u>	<u>Monthly Salary</u>
Typing Pool		Painter	\$1,707
Secretary	\$1,373	Senior Carpenter	\$1,040
Legal Secretary	\$ 665	Maintenance	
Secretary	\$1,122	Carpenter	\$1,707

Source: The New York Times, January 1, 1984.

The Bill for Equity

The goal of those who advocate pay comparability is to bring average salaries for women up to the level of men's salaries. However, little or no attention is paid to the costs involved. For instance, the nation's wage bill in 1982 would have been increased by \$190 billion, or 12.1 percent, if salaries for so-called "female occupations," had been brought up to par with salaries paid in comparable male-dominated positions. The option of achieving comparability by cutting wages for predominantly male jobs is not available since employers are specifically forbidden from lowering the wages of any employee in order to comply with pay comparability laws.

Another problem that arises from mandated pay comparability is how to raise the market value of predominantly female occupations. Do we tell all employers of nurses, for instance, that they have hitherto been paying these persons a wage that is too low, even though these were determined by the marketplace? This places the government in the position of dictating wage rates to the marketplace. In essence, it creates a perverse form of wage controls that tells employers to pay higher wages for certain jobs. This, unfortunately, is not quite as preposterous as it appears at first glance since the federal government already sets minimum wage levels under the Fair Labor Standards Act (FLSA). However, mandated pay comparability would be more job-specific than the FLSA dictates and would, therefore,

require a system of record-keeping akin to that necessary for administering wage and price controls.

Along with the problems of record-keeping and wage determination is that of pay ranges, which for any particular position, vary widely. For instance, a particular individual occupying a job as a secretary sometimes earns twice as much as another person having a similar position in another firm. We would, therefore, have to devise a pay system similar to union or government pay scales that push for equality in pay rather than allowing for differences due to merit of the incumbents in their specific positions.

What the Numbers Don't Tell You

The Department of Labor should clarify the statistics to ensure that the data released is not misused to sensationalize many of the preconceived notions of the most radical critics of American business. The release of data should include clarifications that will ensure that it will not be misused and/or abused. Most of the statistics now being issued are raw data and fail to include caveats explaining the reasons for pay differentials.

While the pay of men and women appears to be significantly different in many cases, even when both sexes occupy the same positions, there is very little evidence that there is a widespread pattern of discrimination on the part of American business. This is supported by the fact that, with 50 million women currently in the labor force, there are less than twenty thousand complaints filed under the provisions of the Equal Pay Act of 1963. Given the litigious nature of our society, this suggests that the preponderance of employers are acting in accordance with the Equal Pay Act of 1963 and the Civil Rights Act of 1964 which require that men and women be paid equal wages.

The following are some of the statistical problems related to the issue of equal pay and which the data issuing agencies should specify more clearly:

Some of the comparative wage data includes both part-time and full-time workers. This tends to overstate the differential between male and female wages. Women are nearly two-and-one-half times more likely than men to work part time. Less than 12 percent of the men in the labor force work part-time schedules, while about 30 percent of the women are part-time workers. This difference in hours worked is contributing to the pay differential. A comparison of the data for full-time workers only, shows less of a sex-based difference in pay. Moreover, analysis of full-time workers in the same occupations shows that the pay is even more comparable.

Even when both men and women work full time, women tend to work fewer hours than men. For exam-

ple, the U.S. Department of Labor defines full-time work as 35 or more hours of work per week. Statistics show that women who work full time are more than three times as likely as men to work less than 40 hours per week. Men, on the other hand, are two-and-one-half times more likely than women to work over 40 hours per week. However, this hours differential is not reflected in the median wage data that places all persons who work more than 35 hours per week in the full-time category. It would, therefore, be appropriate for the Labor Department to note this discrepancy in hours worked in the full-time workers' category.

The average man will spend about 42 percent more of his lifetime in the labor force than the average woman. The chances are still about 50/50 that a woman will drop out of the labor force for a period of time, particularly while she has small children. Statistics show that 55 percent of women with children below the age of six, and 40 percent of those with children between the ages of six and 17, are not in the labor force. Interruptions in labor force participation have a significant impact upon pay as knowledge becomes obsolete at a rapid pace in today's dynamic economy. Periods of absence from the labor force, therefore, result in a depreciation of job skills. As a consequence, the jobs available to those reentering the work force are generally entry level (lower paying) positions.

Another factor that contributes to pay differentials is tenure in a specific job with a specific employer. Because of the importance of seniority in determining wages, two persons performing the same job who have been employed for different time periods by the same employer will generally receive different pay, even if they show the same degree of job proficiency. For example, the government's pay scale for new employees is 75 percent of what high seniority employees receive for doing the same job. The average tenure of men with the same employer is over 50 percent greater than it is for women. And, in the mid-career ages of 45 to 54, when pay tends to be highest, the average tenure for men is 13.4 years, nearly twice the 6.9 years average for women of that same age group. The Labor Department should note these differences in tenure when the data is issued.

Women have inordinate representation in jobs and professions that tend to have more flexible work schedules. It appears that women employees are willing to forgo greater pay for more flexibility. For example, women comprise over 80 percent of all elementary school teachers, an occupation with a work year of about 180 days (most occupations have a work year of about 240 days). Other occupations which employ a preponderance of women, such as nurses and waitresses, may not have shorter workweeks but do have more flexible schedules than most occupations.

Women tend to be less geographically mobile than men. This limits their ability to seek the best opportunities and the highest salaries. For example, during the last recession, there were large numbers of unemployed auto workers, predominantly male, who migrated to Texas and Louisiana in search of high paying jobs in the oil fields, rather than accept lower paying jobs available in Michigan. In contrast, women tend to sacrifice their own career opportunities by staying with their families and are willing to move only in response to better job opportunities for their husbands. A comparative study of the earnings of single women and single men indicates that they have similar employment characteristics and that, therefore, they earn virtually identical wages.

A study conducted by Jacob Mincer and Solomon Polachek indicated that women spend less time than men on productivity-enhancing education and training. This is another factor explaining the existence of pay differentials between men and women. A related factor, which also contributes to some of the observed differential in pay, is the number of years of college attendance. While there are about as many women attending college today as there are men, the historical difference in college attendance is significant. Of all persons in the labor force over the age of 35, men are 50 percent more likely than women to have attended four or more years of college. The Department of Labor data for specific occupational groups does not reflect differences in training and experience.

Thus, the statistical evidence indicates that through choice and chance many women have been concentrated in occupations that pay lower wages. The solution to the problem of pay equity is to ensure that all persons have equal access to all economic opportunities, a goal that was the basis of the Civil Rights Act. It is absurd to even suggest that the marketplace, comprised of more than five million firms, has conspired to hold the wages of women below that of men. The rulings of the courts, until recently, have essentially expressed the view that the law takes note of discrimination against people and not against jobs.

Do Firms Adhere to Equal Pay Principle?

Table 2 shows the results of a study of female/male pay ratios. This study showed that, when taken on a job-to-job/company-to-company basis, women are paid about the same as men. The large disparity in male/female pay is a result of females being perceived as less likely to rise to higher levels within their respective organizations. For example, while 46 percent of the entry level accounting positions are held by women, they occupy only five percent of the top level positions. Therefore, when all women accountants are compared to all male accountants, it is this disparity in job levels that results in women accountants making less money than men. Large numbers of

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TABLE 2
FEMALE-MALE PAY AND EMPLOYMENT RATIOS
1981

<u>Occupational Work Level</u>	<u>Average Monthly Pay</u>	<u>Female-Male Pay Ratio</u>	<u>Female Share of Total Employment</u>
Accountant 1	\$1377	99	46%
Accountant 2	1679	98	34
Accountant 3	1962	95	19
Accountant 4	2402	90	11
Accountant 5	2928	90	5
Accountants (All levels)	1642	71	40
Attorney 1	1873	103	28
Attorney 2	2338	99	24
Attorney 3	3031	95	13
Attorney 4	3738	94	9
Attorneys (All levels)	2364	71	22
Chemist 1	1508	96	38
Chemist 2	1757	94	29
Chemist 3	2120	93	15
Chemist 4	2567	92	10
Chemist (All levels)	2025	70	21

Note: The data for all members of an occupation are annual averages based on unpublished tabulations from the *Current Population Survey* conducted by the U.S. Department of Labor. Data for occupations by level are based on statistics from the Bureau of Labor Statistics 1981 *National Survey of Professional, Administrative Technical and Clerical Pay* (PATC Survey), which covers white-collar employees in medium and large firms.

women have recently entered previously male-dominated professions such as law and accounting, but have not yet been in these professions long enough to rise to higher levels of pay and responsibility. However, pay eventually equalizes as women attain greater tenure and advance to higher level positions.

Table 2 indicates that while there is a pay differential between men and women in the same profession, when taken on a job-to-job basis within organizations, there is virtually no pay differential between the two sexes. The reason for the apparent pay differential appears to be based on the different work levels of men and women related to advancement within occupational groups, rather than pay differences within narrowly defined pay categories.

Conclusion

The data indicate that men and women are receiving equal pay for equal work, but that more men are employed in higher levels of many professional occupations than are women. This difference is, in part, directly attributable to the fact that women have been employed in certain professions, such as accounting and law, more recently than men.

TRENDS IN COMMERCE NOTES ON TABLE II AUGUST/SEPTEMBER 1986

by
Martin Lefkowitz*

Gross National Product (GNP)— Benchmark revisions of the national income and product accounts in July showed that Gross National Product—the total value of goods and services produced in the economy—grew at a 2.8 percent rate in the last two years instead of the previously reported 2.0 percent. Revised data for the second quarter indicate that GNP grew at a 0.6 percent annual rate. However, the economy is not as weak as the GNP data would indicate. Final sales, after adjusting for inflation, grew at a vibrant 3.8 percent rate in the second quarter but the lower rate of inventory build-up, which

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added \$45 billion to first quarter GNP, subtracted \$28 billion from second quarter output. Consumer spending grew at a 6.5 percent rate in the second quarter. Despite a 2.3 percent drop in nonresidential fixed investment, the producers' durable equipment component rose by 19.9 percent. Residential investment remains strong, rising by 13.5 percent in the second quarter. However, the second quarter revision reflected a continuing deterioration in the nation's trade deficit, with exports declining by 5.6 percent while imports rose by 16.5 percent.

The Services Sector— Employment in service sector establishments increased by 363,000 jobs in July and is now 2.6 million jobs above its year-ago level. This compares with an increase of 26,000 jobs in the goods-producing sector during July. Over 99 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.9 percent in June. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 25.7 billion in July, an increase of approximately 12.3 percent from its year-ago level. Over the past seven months, domestic passenger travel has increased 10.2 percent and available seat miles were up 13.0 percent. International passenger traffic, experienced a 6.3 percent decline in July compared to July of last year.

Money Supply— The nation's money supply—as measured by M1, currency in circulation plus demand deposits—increased by 1.2 percent in June and was 12.8 percent above its year-ago level. This is considerably above the Fed's target range of three to eight percent.

Employment— The civilian unemployment rate fell from 7.1 percent of the labor force in June to 6.9 percent in July. Employment in service producing industries grew by 363,000 jobs in July, with much of the gain concentrated in business and health services, retail trade, finance, insurance and real estate. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 390,000 in July after falling 54,000 in June due to several work strikes. After adjusting for workers returning after strikes, however, the July gain was 240,000. Civilian employment—as measured by the monthly survey of households—increased by 210,000 persons and now stands at 109.9 million jobs (after seasonal adjustment).

Consumer Price Index— The Consumer Price Index for all urban consumers (CPI-U) was unchanged in July following a 0.5 percent rise in June. The index for July was 1.6 percent higher than July of last year. While each of the energy components declined, the index for energy commodities dropped 6.3 percent. Excluding energy, the CPI-

U rose 0.5 percentage points in July, largely as the result of increases in the indexes for food and shelter.

The Producer Price Index for finished goods fell by 0.4 percent in July, following a sharp decline during the first 4 months of 1986, before turning up in May, and showing no increase in June. The decline in the index can be attributed to the 11.9 percent fall in energy prices. The intermediate goods index fell by 0.7 percent, also the result of the decline in energy prices. However, the index for intermediate goods, excluding energy, edged up 0.2 percent. After dropping 1.1 percent in June, the crude goods index rose by 1.2 percent in July. Food prices rose 1.9 percent in July after being unchanged in June, and prices other than food and energy rose by 0.3 percent.

Housing Starts— Privately owned housing units were started at a seasonally adjusted annual rate of 1,818,000 units in July, a decrease of 1.8 percent from the June level. July housing starts were 9 percent above the July 1985 level. The July drop reflected a continued decline in apartment construction which many are attributing to the uncertainty over tax reform legislation. Building permits, an indicator of future activity in the home building industry, were down 2 percent for the month.

Corporate Profits and Cash Flow— Corporate profits have been sluggish for the past year. While profits increased by 8.5 percent between the second quarter of 1985 and the second quarter of 1986, they remained below their fourth quarter level of 1985. Economic profits, which takes into account economic depreciation and adjusts for changes in inventory valuation, were up 6.2 percent for the quarter from their year-ago level. Net corporate cash flow, which includes depreciation allowances, increased nearly 3.4 percent over that same period, indicating a strong cash position in the corporate sector.

Industrial Production— Industrial production fell 0.1 percent in July, marking the fifth decline of the index which has occurred this year. Much of the decrease can be attributed to weakness in capital spending and the lack of inventory build-up. Oil and gas well drilling continued its downward trend in July. Manufacturing output was unchanged in July after falling 0.5 percent in June; production by utilities fell by 0.2 percent and mining output dropped by 0.4 percent.

The capacity utilization rate in manufacturing declined 0.2 percentage points in July to 78.2 percent, down from 78.9 percent of capacity in June. The decline was attributable to a significant drop in auto production and in instruments, petroleum products, and rubber and plastic products. Over the past six months, the overall rate has fallen 2.6 percentage points. The capacity utilization rate in nondurable manufacturing was 84.0 percent of capacity, little changed from recent months.

**TABLE II
TRENDS IN COMMERCE**

	Current Period	Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Jun/86 241.4	241.2	239.2	0.0	0.9
Gross National Product (\$B)	II/86 4,179.8	4,149.2	3,965.0	0.7	5.4
Gross National Product (82\$B)	II/86 3,661.5	3,665.9	3,567.6	0.1	2.6
Money Supply (M1) (\$B)	Jun/86 666.7	658.7	590.9	1.2	12.8
PEOPLE AND THEIR MONEY					
Personal Consumption Expenditures (\$B)	Jul/86 2,758.3	2,761.8	2,591.2	-0.1	6.4
Personal Consumption Expenditures (82\$B)	Jun/86 2,424.9	2,410.3	2,316.5	0.6	4.6
Disposable Personal Income (\$B)	Jul/86 2,990.2	2,976.7	2,828.0	0.4	5.7
Disposable Personal Income (82\$)	Jun/86 2,613.6	2,628.0	2,528.0	-0.5	3.3
Personal Savings Rate (%)	Jul/86 4.2	4.0	5.3	0.2[b]	-1.1[b]
Civilian Employment (millions)	Jul/86 109.9	108.6	107.0	0.1[c]	1.6[c]
Civilian Unemployment Rate (%)	Jul/86 6.9	7.1	7.3	0.2[b]	0.4[b]
Average Hourly Earnings	Jul/86 \$8.73	\$8.75	\$8.55	-0.2	2.1
Consumer Price Index (All Urban, 67=100) [a]	Jul/86 328.0	327.9	322.8	0.0	1.6
Purchasing Power of the Dollar (67=\$1.00) [a]	Jun/86 0.305	0.306	0.310	-0.3	-1.6
Prime Interest Rate (%) August 13, 1986	8.0	8.5	9.5	-0.5[b]	-1.5[b]
Retail Sales (\$B)	Jul/86 118.7	118.6	114.6	0.1	3.6
SERVICES SECTOR					
Employment in Services (Millions)	Jul/86 75.4	75.0	72.8	0.5	3.6
Consumer Purchases of Service (\$B)	Jun/86 1,439.9	1,426.5	1,331.8	0.9	8.1
Consumer Purchases of Service (82\$B)	May/86 1,171.8	1,170.6	1,112.0	0.1	3.1
Domestic Revenue Passenger Mileage Flown					
Major Airlines (Billions) [a]	Jul/86 25.7	24.0	22.9	7.0	12.3
BUSINESS PROFITS AND OUTPUT					
Corporate Profits and Cash Flow (\$B)					
Before Tax	II/86 231.9	224.3	213.8	3.3	8.5
Profits Tax Liability	II/86 91.2	89.1	87.1	2.3	4.7
Tax Liability as a Percent of Profits	II/86 39.3	39.7	40.7	-0.4[b]	-3.8[b]
After Tax	II/86 140.8	135.2	126.7	4.1	11.1
Net Cash Flow	II/86 383.4	380.9	370.8	0.6	3.4
Industrial Production (77=100)	Jul/86 124.1	124.2	124.1	-0.1	0.0
Capacity Utilization Rate (Mfg.) (%)	Jul/86 78.5	78.7	80.1	-0.2[b]	-1.6
New Housing Starts (thou. units)	Jul/86 1,818.0	1,852.0	1,673.0	-1.8	8.6
BUSINESS COSTS					
Unit Labor Costs (nonfarm) (77=100)	II/86 169.1	168.8	165.9	0.1	1.4
Unit Nonlabor Costs (nonfarm) (77=100)	II/86 164.8	163.9	160.8	0.5	2.5
Producer Price Indices (67=100) [d]					
Crude Materials	Jul/86 278.0	274.9	303.8	1.1	-8.4
Intermediate Goods	Jul/86 305.0	307.1	318.6	-0.6	-4.2
Finished Goods	Jul/86 288.0	288.9	294.8	-0.3	-2.3
FEDERAL SPENDING AND DEBT					
Federal Spending Index (67=100)	Jun/86 622.3	626.5	583.1	-0.7	6.7
Federal Gov't Gross Debt Outstanding (\$B) [a]	May/86 2,035.6	2,012.6	1,758.3	1.1	15.8
INTERNATIONAL TRADE					
Exports of Goods & Services (\$B)	II/86 375.6	374.8	370.0	0.2	1.5
Imports of Goods & Services (\$B)	II/86 472.0	468.5	447.1	0.7	5.6
Balance on Goods & Services (\$B)	II/86 -96.4	-93.7	77.1	2.9	25.0
WHAT'S AHEAD?					
Index of Leading Indicators (67=100) [a]	Jun/86 178.6	178.1	167.7	0.3	6.4

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted.

[c] January data is a new series that is not comparable to previous data.

[b] Percentage point difference.

[d] Index number not seasonally adjusted, percent change seasonally adjusted.

Productivity—Nonfarm business productivity increased at a seasonally adjusted annual rate of 1.6 percent in the second quarter of 1986. This was about half the 3.3 percent growth rate reported in first quarter. Output rose by 1.3 percent while hours worked declined 0.3 percent. This was the first decline in hours worked since the fourth quarter of 1982 when they fell at a 3.4 percent rate. Manufacturing productivity rose at a 1.9 percent annual rate in the second quarter, and output declined by 1.5 percent, while hours dropped by 3.4 percent. This was also the first quarterly decline in manufacturing output since the fourth quarter of 1982.

Interest Rates—The prime interest rate currently stands at 8.0 percent, 1.5 percentage points below its year-ago level. Three- and six-month Treasury bill rates were both near 5.6 percent in mid-August, about 0.2 percent below their level of a month earlier. Thirty-year Treasury bonds which had traded at about 7.5 percent at the end of July, fell to 7.2 percent in mid-August, about the same level as the beginning of July.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, declined to 622 in June (1967 = 100), a 0.7 percent decrease from the previous month and 6.7 percent below the level of June 1985. Federal receipts for the first nine months of fiscal year 1986 increased by 4.5 percent, while expenditures for the same period rose by 4.2 percent. The federal deficit for the first nine months of fiscal year 1986 was \$166.8 billion compared to \$162.0 billion during the same period in fiscal year 1985.

Personal Savings—The personal savings rate was 4.2 percent of after-tax income in July, higher than the 4.0 percent savings rate in June, and 5.3 percent savings rate in July of 1985.

Retail Sales—Retail sales rose by 0.1 percent in July, following a revised 0.1 percent drop in June. The increase occurred despite the decline in gasoline sales which dropped by 2.6 and apparel store sales which fell by 0.2 percent. The July increase in retail activity was mainly attributed to the rise in sales by major department and grocery stores.

Trade Deficit—On a goods and services basis, the trade deficit in the second quarter of 1986 was \$96.4 billion, slightly more than the \$93.7 billion reported in the first quarter. The continued increase in the trade deficit occurred despite lower oil prices and a significant drop in the value of the dollar. The manufacturing trade deficit continued to grow, reaching the year's high of \$12.7 billion in June on increases in sales of foreign cars, textiles and clothing. Imports, including oil, totaled \$33.2

billion, a 4.4 percent increase over the six-month average. Exports reached a high for the year of \$19.1 billion.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, rose 0.3 percent in June, following a downward revision for May. Six of the 11 indicators were up, three were down, and two remained unchanged. The contributors to the June increase in leading indicators include new orders for consumer goods and industrial materials, contracts and orders for plant and equipment, building permits, money supply, stock prices and change in sensitive materials prices. The three negative contributors were changes in credit outstanding, vendor performance, and average workweek. Over the past six months, the index has risen by 5.7 percent.

HOW PRODUCTS FARE

Exports that increased in past year as dollar fell—

Agricultural machinery	+ 19%
Plastics	+ 19%
Paperboard	+ 11%
Organic chemicals	+ 11%
Pharmaceuticals	+ 10%
Heating, cooling equipment	+ 10%
Pulp, waste paper	+ 8%

Exports that declined—

Corn	- 62%
Iron, steel	- 21%
Wheat	- 16%
Aircraft	- 9%
Instruments	- 5%

Where trade gap widened—

Automobiles	by 36%
Motorcycles, bicycles	by 30%
Textiles	by 21%
Telecommunications gear	by 5%
Lumber	by 3%

Source: U.S. News and World Report, August 11, 1986.

SUMMER YOUTH EMPLOYMENT—1986

In its annual report on summer youth employment, the Bureau of Labor Statistics reported that the number of 16 to 24 year olds in the labor force increased by 3.5 million between April and July of 1986, about the same as last year, but less than the increases of 4.2 and 3.9 million in the summers of 1983 and 1984, respectively. During July 1986, the youth labor force totaled 26.1 million, 500,000 less than the July 1985 level.